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FRAUD AND ABUSE IN THE "HOT ISSUES" AND "PENNY STOCK" MARKETS

HEARING
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
NINETY-EIGHTH CONGRESS
FIRST SESSION
ON
THE EFFORTS OF THE SECURITIES AND EXCHANGE COMMISSION AND THE NATIONAL ASSOCIATION OF SECURITIES DEALERS TO PROTECT THE INVESTING PUBLIC FROM FRAUD AND ABUSE IN THE SO-CALLED "PENNY STOCKS" AND "HOT ISSUES" MARKETS

DECEMBER 15, 1983—NEW YORK, NEW YORK

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CONTENTS

THURSDAY, DECEMBER 15, 1983

New York, New York

Page
Opening remarks of Senator D'Amato 1
  Complete prepared statement of Senator D'Amato 2
Opening remarks of Senator Hawkins 5

Witnesses

John S. R. Shad, Chairman of the Securities and Exchange Commission; John M. Fedders, Director of Enforcement Division; Ernestine Zipoy, Chief of Operational Procedures and Review; Don Malawsky, New York Regional Administrator; Regina Mysliwiec, Assistant Regional Administrator of New York 5
  Prepared statement:
    Introductory and summary 7
    What is a "Hot New Issue?" 12
    The hot new issues market 12
    Regulatory response to the hot new issue phenomenon 14
    The investor's role 30
    Conclusion 31
    Exhibits:
      Exhibit A: Red flags for the investor 32
      Exhibit B: Comparison of Dow industrial average 33
  Prepared statement of John M. Fedders 34
Panel discussion:
  Trading volumes set new precedents 40
  GNP growth rate of 7.7 percent phenomenal 42
  Investors need to read prospectuses 43
  Survival rate for new issues of penny stocks 46
  SEC's problem with aftermarket conduct 48
  SEC's enforcement program with the hot new issue market 50
  Adequate enforcement personnel 52
  Discretion authority needed by SEC 54
Gordon Macklin, president of the National Association of Securities Dealers, accompanied by John E. Pinto, vice president, surveillance, NASD, and Frank J. Wilson, executive vice president and general counsel, NASD 54
  Overview of NASDAQ communication system 55
  Free-riding and withholding 57
  NASDAQ is a three-tier system 59
  Quarterly report under section 13 or 15(d) of the Securities Exchange Act of 1934 62
  Fair dealing with customers 69
  Safeguards on price parameter 71
  Customers reluctant to come forward 73
  "1982 NASDAQ Fact Book" 76

Panel discussion—Continued

Page
Richard H. Jenrette, chairman of the board, Donaldson, Lufkin, and Jenrette 92
  Extraordinarily powerful stock market 92
Thomas I. Unterberg, chairman and senior managing director, L. F. Rothschild, Unterberg, and Towbin 95
  1980–83 market contrasts sharply with 1968–72 market 95
  SEC needs to screen broker-dealers 97
  Security industry has a responsibility to achieve legitimacy 99

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

North American Securities Administrators Association, Inc., testimony of Michael Unger, president 102

FRAUD AND ABUSE IN THE "HOT ISSUES" AND "PENNY STOCK" MARKETS

THURSDAY, DECEMBER 15, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
New York, N.Y.

The subcommittee met at 10:40 a.m. in the U.S. Court of International Trade, One Federal Plaza, New York, N.Y., Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Hawkins.

OPENING REMARKS OF SENATOR D'AMATO

Senator D'AMATO. This hearing will come to order.

I have a full text of my statement which I am going to submit for the record in order to allow more time for the witnesses.

Let me say that we are very much concerned with protecting investors and insuring that they receive adequate protection, and insuring that they are not taken advantage of because of the spectacular increase in the number of public offerings.

The vast majority of these public offerings are sound. They are legitimate requests for capital formation. We should encourage this.

However, we find a proliferation of penny stocks that sell for under $1. Approximately 150 new issues have been offered worth almost $1 billion or half a billion dollars, $400 million of these offerings.

And some of these offerings are absolutely worthless. Some of them are being issued by people who have been barred from trading in commodities.

The question is: What may we do to insure the integrity of the marketplace as well as protect the public from unscrupulous broker-dealers?

What warnings can we give to them; what are the legislative initiatives and efforts?

Let me suggest to you that probably a very small percentage of investors in penny stocks ever see a prospectus.

These small investors never receive the warnings which they are entitled to. They are afraid to ask the broker for a prospectus because in many cases he says, "We are going to sell this issue out by the time I get it to you, you are either going to take it or not. It's a good deal."

The small investors have a right to see the prospectuses—and we have about four or five prospectuses that will illustrate how horrible some of these situations are.

The Lezak Corp., Inc., put out an offering on June 30, 1983. The introductory statement of the company is on page 6 of the prospectus. And I will dare say anybody who read this wouldn't put a penny into it. But people did. They invested $3 million in the corporation.

The prospectus stated: "This is an offering of securities involving an extremely high degree of risk." That is an understatement.

The company was incorporated in January 1983. It has engaged in no business whatsoever and has no plan of operation other than it will not engage in exploration for oil or gas, fuel distribution, or mineral extraction business. It has no operating history and it is embarking upon a novel type of enterprise. The company has no plan of operation and can provide the investor with no information whatsoever as to its intentions.

Now, that's incredible.

If you look at the history of the people who are promoting this you'll find that it's a handful of lawyers and broker-dealers, who should not be allowed in the industry.

And you'll find that many of the people who will be investing in these kinds of companies are people who are least able to afford it: unsophisticated investors.

I don't believe we do the general public any good by permitting this kind of situation.

[Complete prepared statement follows:]

PREPARED STATEMENT OF SENATOR D'AMATO

The hearing will come to order, I have called this hearing, as chairman of the Securities Subcommittee of the Senate Banking Committee, to examine the efforts of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) to protect the investing public from fraud and abuse in the so-called penny stocks and hot issues markets.

These crimes and violations deprive thousands of innocent investors of hundreds of millions of dollars and, in many cases, of their entire life savings. They damage the credibility of legitimate brokers, dealers, and underwriters, and cast doubt on the integrity of the stock market as a whole.

Finally, the manipulations and illegalities prevent countless millions of investment dollars from being used for capital formation to assist truly worthy business projects. Instead of helping legitimate, innovative, American companies to develop their products and to hire additional workers, money diverted to shells merely lines the pockets of the disreputable.

The potential of a hearing such as this for educating the public about how they can better protect themselves from these unscrupulous insiders and broker-dealers is enormous. These people prey on the public's impulse to get in on the ground floor of the next apple computer. This impulse seems to have been particularly strong recently, owing in part to the bull market, when everything seemed to be going up, and in part to the publicity, mostly favorable, concerning new high technology companies, in which fortunes have been made in very short periods of time.

The extent of this problem is illustrated by figures released by the Securities and Exchange Commission, and by a survey recently completed by Venture magazine.

In 1980, there was a total of 3,147 securities offerings filed with the SEC. Their total stated value was $103.6 billion. This year, there have been 6,133 filings with the SEC, or almost two times as many as there were 3 years ago. The total value of this year's filings was $243.4 billion, or almost 2½ times the value of the filings 3 years ago.

The growth in filings for new issues exceeds even this impressive record. In 1980, there was a total of 706 new issues filed with the SEC. Their total stated value was $12.98 billion. This year, there have been 1,967 new issues filed, or 2.8 times as many as there were 3 years ago. The total value of this year's new issues was $56.94 billion, or almost 4½ times the value of the new issues filed 3 years ago.

Not surprisingly, many unscrupulous promoters have attempted to profit, at the public's expense, from this surge of investor interest in the market.

A Venture magazine survey of the 78 initial public offerings [IPO's] in 1982 at $1 or less revealed that 49 percent of them (38) had participants who were convicted felons, securities violators, targets of securities injunctions, reputed crime figures, or principals who face serious charges of insider financial misdealing. Of these 38 issues involving suspicious or convicted participants, 24 also have shareholders who have been convicted of, or enjoined from, securities or criminal violations by the Securities and Exchange Commission or by regional SEC offices. A spot check of new issues in July 1983 revealed that fully half of the 22 companies that went public for $1 or less that month had participants who are related to or are themselves accused securities violators.

The public must be awakened to the fact that they need to study the backgrounds of the officers, directors and principal shareholders of the companies in which they invest. They should learn about the company's transactions with its management and its loans to its officers. The public should ask what is to be done with the money raised by the sales of the company's stock, and about the product or service the company offers. All this, and more, can be learned by reading the prospectus. The disclosure requirements of the securities laws offer the public significant protections, and this hearing will put these protections before the public.

Nothing can better illustrate the usefulness of reading the prospectus than by quoting from a few of them.

In one penny prospectus, the company said that it planned to engage in research, although, "the company has no research facilities nor does it intend to acquire such facilities." Another company had a successful offering despite admitting that it "does not know what business it will engage in, has no plan or operation other than it will not engage in the exploration of oil and gas, and owns no assets."

A third company's prospectus revealed that it had failed to file tax returns since 1971, did not know whether its officers would be able to devote sufficient time to the company, and that it might not be able to continue as a going concern.

We can also educate the public concerning the favorite tricks of those who seek to sell them these worthless stocks, Some of the specific practices we will be examining include:

First, tie-in arrangements, in which brokers force their clients to buy unattractive stocks in order to qualify for promising hot issues;

Second, brokers' refusals to execute, or their unconscionable delays in executing, sell orders in order to maintain their tight control over the market;

Third, persuading a client who has expressed the desire to sell his stock not to do so, but to reinvest the proceeds in a higher priced stock. By rolling over his paper profits from stock A to stock B to stock C, ad infinitum, the customer never sees any cash. Sometimes there is nothing wrong with this, and sometimes there is. We need to educate the public as to the difference; and

Fourth, one of the most abhorrent practices is the fraudulent announcement of a new company venture or product that does not exist, and never will.

This is not to say that "let the buyer beware" is the complete answer to our problem.

The Government can protect the public in ways other than assuring full disclosures. It can and it must prevent criminals and others with a history of illegitimate activity from associating with broker-dealers in order to engage in the sale of worthless stock. This hearing will explore the question of whether the present rules of excluding the disreputable are adequate.

I do not believe that they are, and I plan to present my proposed reform to our witnesses today for their comments. I am particularly concerned that our laws merely push the violators through the revolving door from one field—commodities, for example—to another, such as hot issues and penny stocks.

It is also true that the best laws in the world serve no purpose if we do not enforce them. One question I plan to raise at today's hearing is whether the number of attorneys and investigators is adequate to the task of finding and prosecuting those whose specialty is persuading the public to buy worthless stocks. We will examine, as well, the industry's efforts to police itself and to discipline its members.

Before turning to our first panel, I would like to emphasize the importance of holding this hearing at this time. The bubble of speculation in companies having no chance of success has not yet burst. By alerting the public to the danger posed by its investment in companies not worth the paper their stocks are printed on, we give the public the chance to get out now and put its money in the thousands of worthwhile investments that are available. We may not save any lives at today's hearing, but we can save countless life savings.

We are very fortunate to have here today three panels of distinguished securities professionals to help us examine this problem and to explore possible solutions. The first panel is composed of John S.R. Shad, chairman of the Securities and Exchange Commission; John M. Fedders, Director of the SEC's Enforcement Division; the second panel includes Gordon Macklin, president of the National Association of Securities Dealers, accompanied by John E. Pinto, vice president, surveillance, NASD, Frank J. Wilson, executive vice president and general counsel, NASD; and the third panel is composed of Thomas I. Unterberg, chairman and senior managing director, L. F. Rothschild, Unterberg, and Towbin; Richard H. Jenrette, chairman of the board, Donaldson, Lufkin and Jenrette.

I'm delighted that Senator Hawkins has joined with me. She is the chairman of the Subcommittee on Consumer Affairs on the Senate Banking Committee. We also have a distinguished panel.

I would like to ask Senator Hawkins if she would make her opening remarks.

OPENING REMARKS OF SENATOR HAWKINS

Senator HAWKINS. I want to thank you, Mr. Chairman, for holding these hearings. It's a subject that has been long past due. We should have discussed it in the beginning of the explosion of what they call the hot issues market. The last hot issues explosion, I believe, was in 1981 in Denver.

And as the market went down and as small investors and small speculators read about the big bull market, they want to share in the big bull market. And the best way for most speculators who don't have a lot of money is to invest in the penny stocks.

It's my desire to participate in these hearings today to see if there are abuses. If so, how they can be corrected, how much protection does the public need today because we do have a lot of those who cross over back and forth; and as Senator D'Amato said, convicted in one side of the commodities market who then enter the securities market and then prey on the unsophisticated and the unlearned who do want to benefit a little bit when they see the stock market go up and interest rates staying at a rather stable level.

So as chairman of the Consumer Affairs Committee I feel this bears heavily on consumers everywhere. It affects the entire market and it affects legitimate brokers as well as illegitimate brokers.

And we are very thankful other members of the panel are here today to shed some light on the solution to the problem.

Thank you, Senator D'Amato.

Senator D'AMATO. We will proceed with our first panel, John Shad, Chairman of the SEC, John Fedders, Director of Enforcement, Ernestine Zipoy, Chief of Operational Procedures and Review, Don Malawsky, the regional administrator, and Regina Mysliwiec, assistant regional administrator. We are delighted to have you. I'll leave it to you whether John Fedders or John Shad will begin.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY JOHN M. FEDDERS, DIRECTOR OF THE ENFORCEMENT DIVISION, ERNESTINE ZIPOY, CHIEF OF OPERATIONAL PROCEDURES AND REVIEW, DON MALAWSKY, NEW YORK REGIONAL ADMINISTRATOR, AND REGINA MYSLIWIEC, ASSISTANT REGIONAL ADMINISTRATOR OF NEW YORK

Mr. SHAD. Thank you very much, Senator D'Amato.

Chairman D'Amato, Senator Hawkins, and other members of the subcommittee:

The Securities and Exchange Commission appreciates this opportunity to participate in these timely hearings on the hot new issue market.

With me here today, on my left, is Ernestine Zipoy who is the Chief of the Office of Operational Procedures and Review which deals directly in this area of the marketplace, filings with the SEC.

And on my right, John Fedders, the Director of Enforcement.

And to his right is Don Malawsky, the New York regional administrator.

And on the far right is Regina Mysliwiec, who is the assistant regional administrator of New York.

I would like to give a background statement of what has been going on in this market and put it in perspective.

And Mr. Fedders will then give an amplification in terms of the enforcement efforts of the Securities and Exchange Commission.

Mr. Fedders and I have previously submitted a formal statement which we would appreciate having included in the record if there are no objections.

Senator D'AMATO. Without objection. It will be introduced into the record.

[Complete statements follow:]

WRITTEN STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, AND JOHN M. FEDDERS, DIRECTOR, DIVISION OF ENFORCEMENT, OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, REGARDING THE HOT NEW ISSUE MARKET

December 15, 1983

Chairman D'Amato and members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to participate in these timely hearings on the hot new issue market.

Introduction and Summary

Based on the dollar volume of financings and transactions between August, 1982, and June, 1983, the United States has just witnessed the broadest and strongest stock, bond and new issue market in history.

The broad-based Standard and Poor's 500 Stock Index and the New York Stock Exchange Composite Index have each risen approximately 70%, on unprecedented trading volume. Since June, 1983, the market has been backing and filling -- moving sideways -- which has also dampened the new issue market.

During the SEC's fiscal year ended September 30, 1983, corporate financing filings increased 40% to a record 6,100. The dollar volume increased 57% to a record $243 billion. Of these, nearly 2,000, aggregating $57 billion, were initial public offerings.

The strong markets and record volume of financings to date reflect, among others, the following considerations. Since 1981, the rate of inflation has been reduced by over 60%, the prime rate by 50%, the maximum federal tax rates on interest, dividends and capital gains have been reduced by over 25%, and our productivity growth rate for manufacturing has more than quadrupled. It is now growing at an extraordinary 7.4% annual rate and our Gross National Product at a phenomenal 7.7% annual rate. While such extraordinary growth rates can not be sustained, they clearly signal the economy's improving prospects.

Within the past 12 months, the unemployment rate has dropped an exceptional 2 1/2 full percentage points from 10.7% in December, 1982, to 8.2% today. This year's corporate profits are expected to exceed 1982's by 30% and the prospects for 1984 are excellent. The record volume of financings is strengthening corporate balance sheets, and augurs well for future capital goods expenditures to expand and modernize the nation's production facilities.

The securities markets to date have not been characterized by the speculative excesses of the late 1920s. The present 50% margin requirement compares with 10% to 20% then. In the late 1920s, a large portion of total bank credit was being used to finance the stock markets. Today, it is a tiny portion of total bank credit, and publicly owned companies are subject to the SEC's full disclosure requirements, which did not exist in the 1920s.

Since 1952, we have witnessed seven bull market tops at four to five year intervals. In the final stages of most of these bull markets, initial public offerings have risen to over 40%, and ranged up to 64%, of the total number of public offerings filed with the SEC. In fiscal 1983, initial public offerings amounted to 33% of the total. Based on dollar volume, the vast majority of these financings have been for companies with historical operating records. In fact, highly promotional offerings of companies without operating records represent less than 2% of the $57 billion of initial public offerings in fiscal 1983. These include approximately $2 billion of S-18 (short form) securities offerings by small companies.

However, during the euphoric stage of new issue markets, many initial public offerings rise to dramatic premiums. As such markets progress, some investors abandon caution and are victimized by unscrupulous promoters and broker-dealers.

It is at such stages that increasing numbers of highly promotional offerings with little hope of financial success are distributed to the public. Many are priced at less than $2.00 per share. Some of the companies' only appeal is their names, which suggest high technology or exotic products and services. They do not have successful operating records or experienced management. The public provides the bulk of the capital and receives a small portion of the equity. The promoters receive large fees and compensation, and sometimes sell or lease properties to the companies on less than arms' length terms. Despite full disclosure of these matters in prospectuses, such offerings are often oversubscribed.

Investors' willingness to speculate on hot new issues is not a subject of government regulation. The problems addressed by the SEC and the self-regulatory organizations are the illegal practices of promoters, underwriters, and broker-dealers that often accompany hot issue markets. These include:

- stimulating pre-offering publicity in order to condition the market for an offering;
- holding back a portion of an offering in order to increase its scarcity value and sell the shares at a higher price in the after-issue market;
- manipulating the price or volume of transactions in order to stimulate interest in the stock;
- circulating false rumors;
- requiring investors who want to participate in a hot new issue to agree to buy additional shares at higher prices in the after-market, purchase shares in other promotional offerings, or not sell their shares; and

- violating the customer suitability, funds segregation, escrow, net capital and other requirements.

By effectively enforcing the full disclosure and broker-dealer regulations, the SEC, the NASD and the securities exchanges inhibit violations, but they can only prosecute after violations occur. Such is, of course, the nature of law enforcement.

The best protection against hot new issue market abuses is a well-informed investing public. As set forth below, investors can protect themselves by following certain cautionary rules of thumb. 1/ Investors should be wary of unsolicited offers of extremely low-priced securities and large profit projections. Investors should insist on receiving and reviewing prospectuses, especially the section detailing high risk factors. Care should be exercised in selecting a broker who will deal with the investor fairly and efficiently.

It is important to emphasize two distinct elements of the hot issue phenomenon. On one hand, the Commission uses the tools available -- primarily enforcement actions -- to address regulatory problems which emerge during hot issue markets. The Commission has been active in identifying and prosecuting violations, and is doing so today. On the other

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1/ Attached as Exhibit A is a detailed list of "Red Flags for the Investor".

hand, hot issues are a result of market cycles and the optimism that accompanies bull markets. To address this aspect of the issue, it is necessary to educate the public by publicizing the facts in hearings such as this.

What Is A "Hot New Issue"?

A "hot new issue" is an oversubscribed initial public offering of common stock. Because the demand exceeds the size of the offering, "hot new issues" typically rise rapidly when trading commences to substantial premiums over the offering price. Such offerings may trade at several times the offering price within a few weeks.

Problem hot new issues are highly speculative, initial public offerings by companies with little or no operating record and negligible net worth. Despite detailed disclosures, some are significantly oversubscribed and immediately command premium prices in the after-issue market.

The Hot New Issues Market

Hot new issue markets have been with us at least since the collapse of the South Sea Bubble in 1720. 2/ They occur every few years, typically in the late stages of a bull market. 3/ Many investors abandon normal prudence. When the

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2/ The South Sea Bubble was a vast stock enterprise for trading with Spanish South America put in operation in England about 1711. It collapsed in 1720, causing widespread financial ruin.

3/ *See* the attached chart of market cycles. Exhibit B.

general market turns down, highly promotional issues often collapse. There is no bid for many such securities. The issuing companies often go into bankruptcy and the broker-dealers that brought them public disappear.

What makes issues "hot" is an imbalance in supply and demand. The demand is sometimes the consequence of a reasoned judgment by buyers that a security is undervalued by the market. However, the prices of securities are often buoyed not by a rational evaluation of the issuer's business prospects, but by the expectation that other buyers will be willing to pay a higher price for the stock. This is the "Greater Fool Theory."

The demand for hot new issues is in part a consequence of "mass psychology." Once a hot new issue market develops, it feeds on itself. Investors see others turning a quick profit and become convinced they can too. They begin to jump on the bandwagon, buying new issues because they are new issues -- with little or no regard for the business prospects of the issuer.

Although hot new issue markets differ in the type of companies' shares that are in great demand, they are otherwise very similar. Hot new issue markets are characterized by speculative fever. The pursuit of large profits creates an environment in which virtually all new issues thrive. The possibility of large profits motivates investors to purchase securities at prices that bear little or no relationship to the market in general or conventional investment values.

The majority of initial public offerings are by issuers with genuine business operations. Many offerings, however, are by companies whose only asset consists of an idea and whose management is inexperienced in the proposed area of business. Despite full disclosure of such facts, they are often oversubscribed.

Hot new issue markets often have distinct geographical centers. Most have been centered in New York. However, Denver has long been the penny stock capital of America. Indeed, the Denver market has been an area of longstanding concern to Colorado Congressman Timothy Wirth, the SEC and the self-regulatory organizations.

Since 1979, there have been approximately 500 public offerings in the Denver market. These offerings were underwritten by more than 20 regional broker-dealers. The number of broker-dealers participating in this lucrative hot issue market has increased yearly.

Regulatory Response to the Hot New Issue Phenomenon

A. Studies of the Hot New Issue Markets

The Commission has devoted substantial efforts to understanding the phenomenon of hot new issue markets. It has performed several formal and informal studies aimed at identifying problems unique to such markets and has formulated appropriate regulatory and enforcement responses designed to address disclosure and market-related problems that are typical of such markets.

The 1959-61 bull market witnessed a record number of initial public offerings. In response, the Commission conducted a study focused on the responsibilities of the underwriting and brokerage communities to issuers and the investing public. The results of this study were included in the Commission's 1963 Special Study of the Securities Markets, which made a number of recommendations concerning underwriting practices, distribution and aftermarket trading of new issues. Many of these recommendations were later adopted by the Commission and the NASD.

In response to a substantial increase in initial public offerings of small companies during 1967-71, the Commission conducted another study of the hot new issue markets. In 1972, the Commission held public fact-finding investigatory proceedings to determine the adequacy of existing regulatory protections for investors. In mid-1972, a joint SEC-NASD task force was formed to address manipulative broker-dealer new offering practices. The Commission brought a number of injunctive and administrative proceedings as a result of the task force's investigations.

In 1973, the Commission amended the registration and reporting forms to require more meaningful disclosure and requested the NASD to establish appropriate standards to alleviate some of the problems -- particularly relating to the adequacy of underwriters' investigations and the suitability for the customers to whom the securities were being distributed.

B. Disclosure and Hot New Issues

The Securities Act of 1933 requires that, before most public offerings, a detailed registration statement must be filed with the Commission and become effective, and that all investors must be provided a prospectus containing the most significant information in the registration statement. Consistent with the philosophy of the federal securities laws, the disclosure system administered by the Commission is designed to produce securities markets in which full and accurate material information about securities offerings is readily available to the public. It does not substitute governmental decisions about the merits of an investment for those of investors.

It is not possible to legislate out of existence excessive optimism or pessimism. The disclosure provisions of the Securities Act are of little value to a purchaser who does not care about a company's asset value, operating history or prospects, but who buys only in the expectation of an immediate premium. As markets build to buying crescendos, caution gives way to greed, and, as falling markets approach selling climaxes, logic gives way to panic.

New issuers are required to make full disclosure of all material negative and affirmative facts. However, consider the following examples:

- One company filed a Form S-18 registration statement in May, 1983 for a maximum of 50,000,000 units at 1 cent per unit. Each unit consist of a common share and warrant. The prospectus stated, under "High Risk Factors",

> "The Company has been recently organized, has not yet commenced commercial activities, has no revenue, earnings or operating history and is dependent upon the net proceeds of this offering in order to commence commercial operations."

The registration statement also informs prospective investors that

> "The Company currently has no full-time employees and even upon completion of this offering none of its four officers and directors will be devoting a significant portion of their time to the Company's day-to-day activities and affairs . . . Accordingly, while the Company will attempt to solicit business through its officers and directors for its proposed endeavors, there can be no assurance as to the volume of business, if any, which the Company may succeed in obtaining, nor that its proposed operations will prove to be profitable."

- Another company's filing of 39 million shares at $.0151 per share disclosed that the principal shareholder and vice-president, an unemployed 21-year old, intends to devote 10% of his time to the company, which was organized to sell medical equipment. Two others intend to devote 3% of their time to the company. The company was incorporated two months prior to the filing of the registration statement, and had no operating history.

The Commission's task is to ensure full disclosure of all material facts, and to leave investment decisions to the private sector. All speculative companies are not necessarily doomed to failure. We must not stifle entrepreneurial initiative.

A recent Commission analysis of the aftermarket performance of 69 initial public offerings of common stock filed on Form S-18 that came to market between April, 1979 and September, 1980, discloses that as of October 31, 1983, 78.2% were still in operation. An initial investment of $100 in each of these initial public offerings ($6,900) would be worth $7,569 today -- a 9.7% increase. A similar $6,900 investment in the NASDAQ Composite would have been worth $12,017 -- a 74.2% increase.

Some have suggested "merit regulation" of the securities markets through the enactment of minimum federal standards, such as a minimum price level and a prior operating history of the issuer. Their objective would be to prevent the public from investing in certain types of speculative offerings that involve an extraordinary degree of risk.

Congress determined that the hazards and burdens of federal merit regulation outweigh the potential benefits. The congressional concerns that led to this conclusion are still valid. Such federal standards could slow capital formation, stifle the growth of many companies and inhibit competition. The investing public would be deprived by government fiat of certain investment opportunities. There is always a high risk to speculative offerings, but also a potentially high reward in the event the enterprise is successful.

Our system of federal regulation of securities offerings has operated well for over 50 years. Its premise that federal intrusion in the capital formation process should be limited to assuring full and fair disclosure of securities offerings has resulted in lasting benefits for the investing public and issuers. As Huston Thompson, one of the drafters of the Securities Act, pointed out, the Act did "not attempt to prevent investment in speculative projects, inasmuch as many of the industrial developments in this country began as speculations."

America has today, by far, the best securities markets the world has ever known -- the broadest, the most active and efficient, and the fairest.

C. Market-Related Practices and Problems

The principal problems in the hot new issue markets are in the methods and patterns of distribution and aftermarket trading. They fall into two categories -- (1) artificial restrictions on the supply of a security, and (2) devices designed to create a false impression of the market for a security.

The following are examples of illegal practices of which investors should be aware:

1. Underwriters may engage in "tie-in" arrangements whereby they require prospective members of the underwriting syndicate or customers, in return for an opportunity to buy one hot issue stock, to either (a) put in an aftermarket bid for additional shares at an increased price, or (b) purchase shares in another offering.

2. "Parking arrangements" under which underwriters park shares in certain nominee accounts, foreign bank accounts or with broker-dealers for the benefit of the promoters or the underwriters.

3. Investor funds escrowed until an offering is completed may be prematurely used by the underwriters or promoters.

4. Underwriters may not deliver stock certificates to customers so that any subsequent sales must be made through the underwriter. When the customer places a sell order, the underwriter may then refuse to execute the order. In this manner, the broker controls the supply of the shares in the aftermarket. If the purchaser places a sell order that the underwriter believes is untimely, the customer may not be offered future hot issues.

5. There also can be underwriting abuses involving so-called "wooden tickets." Here, investors receive con-

firmations of purchases that they never ordered. They are then informed that the stock is quoted at a higher price. They generally pay for the shares, and often watch them subsequently decline in price.

6. Underwriters and brokers also may fail to adhere to requirements to deliver prospectuses to investors.

D. Other Problems

Most of the difficulties presented by hot new issue markets are found in the methods and patterns of distribution and aftermarket trading. However, willful violations include:

1. Some issuers describe the proposed use of funds in one fashion, and in fact utilize the proceeds for other activities. Funds have been misappropriated or used to buy-up or complete the offering.

2. There have been disclosure problems relating to "undisclosed principals" and the professional background of management.

3. There have been false and misleading statements in press releases and SEC filings, and improper disclosure of underwriting arrangements.

4. "Gun jumping" consists of attempts to attract publicity to an offering and "condition the market" before a registration statement is filed with the Commission or becomes effective.

5. "Road show" sales meetings have been held from town to town to promote an offering. Misleading statements by officers of the issuer and the underwriters create demand for the stock.

The Commission's examination of the problems in the hot new issue markets in the 1972 hearings resulted in significant amendments to the Commission's registration and reporting requirements. The amendments required more meaningful disclosure from all registrants, including information concerning the status of new product development and general competitive conditions, the position of the issuer in the industry in which it operates, and, in the case of certain registrants offering securities for the first time, a description of their plan of operation. Particular emphasis was placed on the disclosure of such plans relating to new ventures. Significant amendments to then-existing industry guides also were implemented, providing for more extensive disclosure in prospectuses and a requirement that all prospectuses include a summary of key information.

Form S-18 is a simplified registration statement designed to respond to a Congressional mandate to facilitate small businesses' access to public capital markets. It has substantially displaced Form S-1 for initial public offerings below $5 million. Form S-18 requires less disclosure than Form S-1, but it generally eliminates only those disclosures that are not important for first-time issuers. It requires extensive disclosure of matters that are of significance in the hot new issue context -- risk factors, plan of distribution, management experience, and use of proceeds are a few pertinent examples. Form S-18 demonstrates how capital formation for small businesses can be encouraged, while providing for full disclosure of all relevant information regarding the speculative nature of such issues.

Those who engage in these and other illegal activities are prosecuted by the SEC and the NASD. The Commission also is concerned with the activities of broker-dealers who attempt to manipulate the aftermarket price of an issue. These practices not only violate the antifraud provisions of the Federal securities laws, but also the NASD's Rules of Fair Practice. For example, the NASD rules seek to prevent the practice of "withholding", that is, failing to distribute all of an issue by putting it into related accounts, by requiring that every NASD member participating in a distribution as an underwriter or selling group member has a duty to make a "bona fide" distribution of the issue. As interpreted, this rule applies to all persons who are in a position to artificially restrict the supply of securities in a distribution including, for example, finders, attorneys, accountants, persons connected with banks, institutional sources of business, investment advisers, officers, directors, partners and employees of members, any broker-dealer or associated person of such broker-dealer, and any member of the immediate families of such persons.

The NASD's Rules of Fair Practice also include a "suitability" rule which prohibits broker-dealers from recommending speculative, low-priced securities to customers "without knowledge of or attempt to obtain information concerning the customers' other securities holdings and their financial situation and other necessary data."

The NASD's "Fair Dealing with Customers" rules prohibit "wooden tickets", fictitious accounts, and abuses of discretionary accounts, including unauthorized transactions in such accounts. The rule classifies all these activities as fraudulent. Further, the NASD's Rules of Fair Practice prohibit excessive mark-ups and the use of manipulative, deceptive or other fraudulent devices or contrivances in connection with securities transactions.

E. The Commission's Enforcement Response

When new issue markets collapse, investors file complaints with the SEC and the NASD and cooperate in investigations. However, during euphoric stages of hot new issue markets, the investigation and prosecution of underwriting abuses and aftermarket misconduct is not as simple as one might assume. First, it is not always easy to locate investors because the records of sales and resales are not adequately maintained. Second, even when investors are located there are difficulties in obtaining their cooperation. Frequently, the customers are involved in more than one hot issue with the same broker-dealer, and do not want to take action jeopardizing their participation in future hot issues. Third, regardless of whether customers have lost money on a particular hot issue, overall participation in the offerings represents an opportunity for a cash windfall, whereas the Commission may not represent to them the opportunity for even the refund of their lost investment or profits in a particular offering under investigation. Fourth, prosecution of particular abuses such as "parking" stock may be problematic, because of the difficulty in proving that the underwriter had an interest in the "customer" accounts in which the stock was placed.

Nonetheless, the Commission has taken vigorous enforcement action relating to the hot issue markets. The Commission has exposed and prosecuted cases involving false and misleading prospectuses, misleading press releases, market manipulation, undisclosed promoters and inadequate disclosure of management competence and experience.

In addition, the Commission has uncovered numerous incidences of illegal and improper activities by broker-dealers. These activities include failure to perform "due diligence", parking, tie-in arrangements, abuses in discretionary accounts, failure to deliver prospectuses, false and misleading statements, market manipulation, free-riding and withholding. Inspections and investigations have also indicated that some broker-dealers lacked operating expertise, sufficient capitalization, and the back office capability to comply with the Federal securities laws.

The Commission also works closely with the NASD in investigating and prosecuting misconduct associated with hot new issue markets. In February 1982, the Commission and the NASD formed a task force to investigate and prosecute violations in the Denver new issue market. In this joint effort, the NASD provided 38 experienced examiners from 14 district offices throughout the U.S. and top officials from the NASD's Washington office. The Commission provided 16 experienced examiners from nine regional offices, as well as staff from the Division of Market Regulation.

Approximately 27 broker-dealers were examined; 10 voluntarily ceased business after extensive negotiations with the staff; and six reopened after substantial additions to their capital, correction of their books and records and other corrective measures. In an effort to protect the investing public and curtail violative conduct by broker-dealers, civil actions were instituted by the Commission against five brokerage firms, three of which are now in SIPC liquidation. Twenty-seven other firms continued to require close monitoring, and additional investigation was required during the following months for approximately 15 firms.

The Commission has brought numerous enforcement actions in connection with the hot new issue market. For example:

- American Western Securities, Inc. Commission enforcement actions against American Western Securities, Inc. ("Amwest") culminated in the revocation of Amwest's broker-dealer registration. In an administrative proceeding brought in 1979 and a civil injunctive action brought in March, 1982, Amwest and certain of its principals and employees consented to charges of fraud in connection with the underwriting and aftermarket trading in speculative OTC issues.

The Commission alleged that Amwest, among other things, manipulated the aftermarket prices of Solar Development and Greenwood Resources, Ltd. In each of these cases, the Commission alleged that Amwest entered artificially high quotes in the aftermarket and created artificial volume by having some salesmen recommend that customers purchase and other salesmen recommend that customers sell these securities. The Commission also alleged that Amwest controlled a substantial percentage of the securities of both these offerings and used this domination and control to facilitate the manipulation of the market price of the securities. In the case of Greenwood Resources, for example, the Commission alleged that Amwest was able to raise the bid price through market domination, cross trades between customers and entering artificially high quotes from $1 7/8 (bid) on August 7, 1978 to $3 (bid) on August 18, 1978.

- Alpha Energy and Gold. This matter involves low-priced speculative securities traded in both the Denver and Salt Lake markets. The issuer distributed allegedly false and misleading press releases that gave the impression Alpha was in sound financial condition and was in the process of mining a gold "ore body". The press releases created trading activity in the OTC market and the price of the common stock rose from $.25 bid in May, 1979 to over $5 bid in late February, 1980. In March, 1980, the Commission ordered a ten-day suspension of trading in Alpha securities. A permanent injunction has been secured against the responsible parties.

- In the Matter of Chatfield Oil & Gas, Ltd. This case involves a speculative new issuer, a Denver penny stock broker and false statements at a public, so called "due diligence" meeting. Chatfield was organized primarily to acquire, explore, develop and operate oil and gas properties. The registration statement allegedly falsely stated the percentages of Chatfield's net revenue interests in three of its four geological interests, and public statements were made that allegedly contradicted the registration statement. The Commission suspended Chatfield's registration statement before any shares could be sold and on December 28, 1981, a stop order was issued by consent. These examples demonstrate that the Commission is able to move swiftly and efficiently against issuers who disseminate false information.

The Commission -- along with the Commission-NASD task force -- continues to monitor the hot issue market. And, in fulfillment of its regulatory responsibility, the Commission will continue to investigate and bring enforcement actions against persons violating the Federal securities laws. In addition, the NASD has pledged its efforts to explore areas in which they might formulate rules or adopt interpretations to further address abuses occurring in the hot issues market.

As part of recent efforts and after careful planning, in September 1983, the Commission and the NASD began a joint effort to increase our presence in the New York hot issue market. With personnel from the Commission's New York Regional Office and from the Divisions of Enforcement, Market Regulation and Corporation Finance and the NASD, we identified numerous broker-dealer firms that had been active in the new issues market within the last year. Nine firms were selected for examination and inspection and 24 public offerings were reviewed. On Wednesday morning, September 21, 1983, small inspection groups from the Commission and the NASD arrived simultaneously at the brokerage firms for the purpose of inspecting and reviewing their activities in connection with certain specified hot issues. Books and records were examined to determine whether there may have been recordkeeping, sales practices or other violations of the federal securities laws or NASD rules by the firms. The inspections uncovered problems which are now being investigated by the Commission and/or the NASD.

The Investor's Role

The best protection against hot new issue market abuses is a well-informed investing public. Too few investors read the prospectuses of hot new issue companies when making investment decisions. Some investors ignore the economic reality of their investments. Others may not sufficiently understand the market mechanics which produce the hot issue phenomenon.

There are certain telltale signals that should serve as "red flags" to investors in hot new issue markets. Investors should be wary of:

- extremely low priced stocks -- penny stocks are often the lowest value investments;
- unsolicited, high-pressure telephone sales;

- brokers who refuse or are reluctant to provide prospectuses;
- tie-in arrangements, under which investors are pressured to purchase additional shares in the after-market, or shares in another offering;
- brokers who do not provide price quotations;
- securities with extremely wide spreads between the bid and asked prices;
- brokers who resist sell orders;
- and brokers who promise extraordinary profits.

Customers can protect their interests by:

- insisting on receiving and reviewing prospectuses;
- meeting with brokers in their offices to discuss the customers' investment interests and the specifics of the securities recommended;
- and by referring to the NASD any refusal by brokers to accept sell orders, or to follow other instructions.

Conclusion

Under the Federal scheme of regulation, the role of the Government is to enforce full disclosure of material information, to enforce rules governing underwriting, selling and trading and to sanction violations. Hot new issues necessitate a disclosure process that is especially refined and adapted to enable reasonably diligent investors to assess the risks and rewards of investing in new ventures. The Commission's disclosure program is subject to continuous review and improvement, and is vigilantly enforced. The Commission devotes its resources to emerging problems as they are detected for the benefit of public investors. While critical comments have been made concerning possible stigma being attached to all low price securities, the Commission is committed to correcting abuses without imposing unnecessary burdens on the legitimate capital-raising mechanism.

EXHIBIT A

RED FLAGS FOR THE INVESTOR

Certain telltale signals should serve as "red flags" for investors in hot new issue markets. Investors should be wary of:

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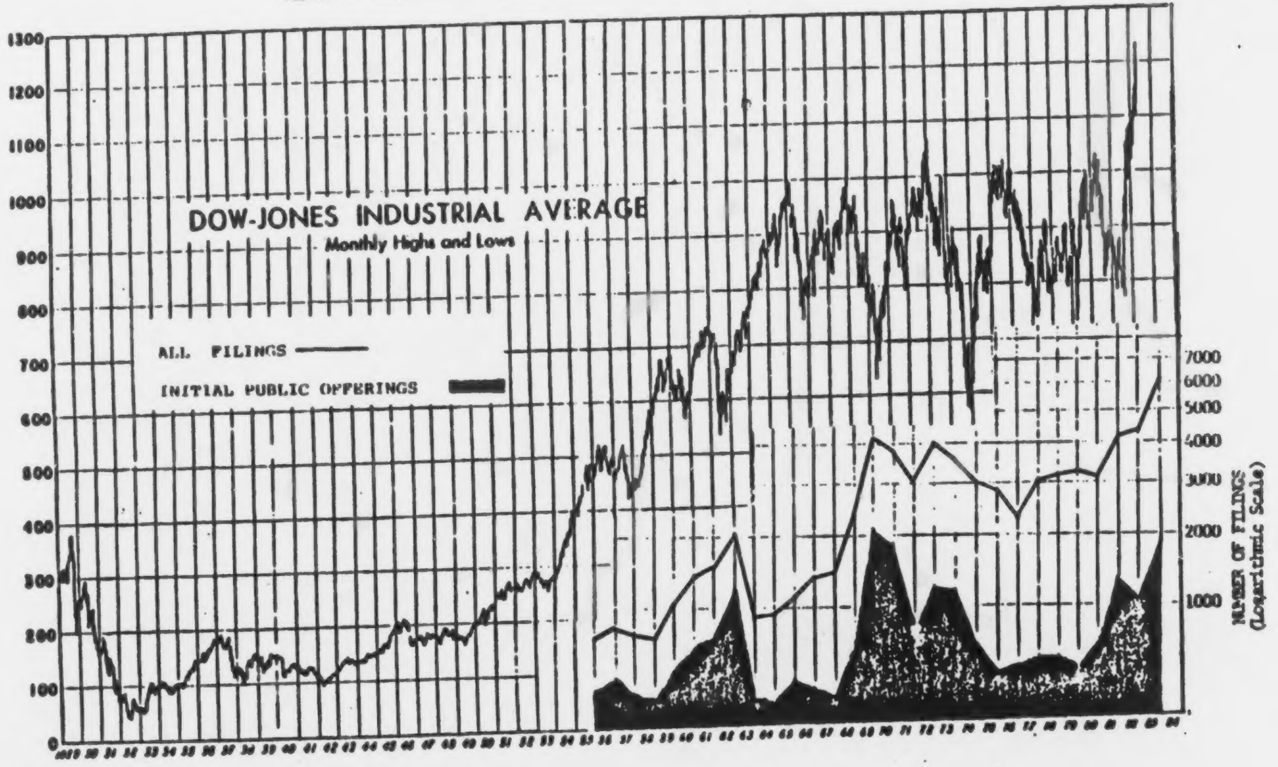
Exhibit B

COMPARISON OF DOW INDUSTRIAL AVERAGE
WITH
VOLUME OF REGISTRATION STATEMENTS VOLUME OF INITIAL PUBLIC OFFERINGS



Dow-Jones Industrial Average from Moody's Handbook of Common Stocks (Summer 1983 Edition)

DIVISION OF
ENFORCEMENT

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

ORAL STATEMENT OF JOHN M. FEDDERS, DIRECTOR, DIVISION OF ENFORCEMENT SECURITIES AND EXCHANGE COMMISSION BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, REGARDING THE HOT NEW ISSUE MARKET

December 15, 1983
New York, New York

Chairman D'Amato and members of the Subcommittee:

It is a pleasure to testify with Chairman Shad about the "hot new issue" market.

The principal problems in the hot new issue market are in the methods and patterns of distribution and aftermarket trading. They fall into two categories -- (1) artificial restrictions on the supply of a security, and (2) devices designed to create a false impression of the market for a security.

The following are six examples of illegal practices in such market:

1. Underwriters may engage in "tie-in" arrangements whereby they require prospective members of the underwriting syndicate or customers, in return for an opportunity to buy one hot issue stock, to either (a) put in an aftermarket bid for additional shares at an increased price, or (b) purchase shares in another offering.

2. "Parking arrangements" under which underwriters park shares in certain nominee accounts, foreign bank accounts or with broker-dealers for the benefit of the promoters or the underwriters.

3. Investor funds escrowed until an offering is completed may be prematurely used by the underwriters or promoters.

4. Underwriters may not deliver stock certificates to customers so that any subsequent sales must be made through the underwriter. When the customer places a sell order, the underwriter may then refuse to execute the order. In this manner, the broker controls the supply of the shares in the aftermarket. If the purchaser places a sell order that the underwriter believes is untimely, the customer may not be offered future hot issues.

5. There also can be underwriting abuses involving so-called "wooden tickets." Here, investors receive confirmations of purchases that they never ordered. They are then informed that the stock is quoted at a higher price. They generally pay for the shares, and often watch them subsequently decline in price.

6. Underwriters and brokers also may fail to adhere to requirements to deliver prospectuses to investors.

In addition to the aforementioned underwriting and market abuses, there are other types of willful violations of the securities laws in the hot new issue market. For example:

1. Some issuers describe in the prospectus the proposed "use of funds" in one fashion, and in fact utilize the proceeds for other activities. Funds have been misappropriated or used to buy-up or complete the offering.

2. There have been prospectus disclosure problems relating to "undisclosed principals" and the professional background of management.

3. Promoters employ a practice known as "gun jumping" where attempts are made to attract publicity to an offering and "condition the market" before a registration statement is filed with the Commission or becomes effective.

4. "Road show" sales meetings have been held from town to town to promote an offering. Misleading statements by officers of the issuer and the underwriters create demand for the stock.

Those who engage in these and other illegal activities will be investigated and prosecuted by the SEC and the NASD.

The Commission works closely with the NASD in investigating and prosecuting misconduct associated with hot new issue markets. In February 1982, the Commission and the

NASD formed a task force to investigate and prosecute violations in the Denver new issue market. In this joint effort, the NASD provided 38 experienced examiners from 14 district offices throughout the U.S. and top officials from the NASD's Washington office. The Commission provided 16 experienced examiners from nine regional offices, as well as staff from the Division of Market Regulation.

Approximately 27 broker-dealers were examined; 10 voluntarily ceased business after extensive negotiations with the staff; and six reopened after substantial additions to their capital, correction of their books and records and other corrective measures. In an effort to protect the investing public and curtail violative conduct by broker-dealers, civil actions were instituted by the Commission against five brokerage firms, three of which are now in SIPC liquidation. Twenty-seven other firms continued to require close monitoring, and additional investigation was required during the following months for approximately 15 firms.

As part of recent efforts and after careful planning, in September 1983, the Commission and the NASD began a joint effort to increase our presence in the New York hot issue market. With personnel from the Commission's New York Regional Office and from the Divisions of Enforcement, Market

Regulation and Corporation Finance and the NASD, we identified numerous broker-dealer firms that had been active in the new issues market within the last year. Nine firms were selected for examination and inspection and 24 public offerings were reviewed.

On Wednesday morning, September 21, 1983, small inspection groups from the Commission and the NASD arrived simultaneously at the brokerage firms for the purpose of inspecting and reviewing their activities in connection with certain specified hot issues. Books and records were examined to determine whether there may have been (i) recordkeeping, (ii) sales practices or (iii) other violations of the federal securities laws or NASD rules by the firms. The inspections uncovered problems which are now being investigated by the Commission and/or the NASD.

When new issue markets collapse, investors file complaints with the SEC and the NASD and cooperate in investigations. However, during euphoric stages of hot new issue markets, the investigation and prosecution of underwriting abuses and aftermarket misconduct is not as simple as one might assume. First, it is not always easy to locate investors because the records of sales and resales are not adequately maintained. Second, even when investors are located there are difficulties in obtaining their cooperation. Frequently, the customers are involved in more than one hot issue with the same brokerdealer, and do not want to take action jeopardizing their participation in future hot issues. Third, regardless of whether customers have lost money on a particular hot issue, overall participation in the offerings represents an opportunity for a cash windfall, whereas the Commission may not represent to them the opportunity for even the refund of their lost investment or profits in a particular offering under investigation. Fourth, prosecution of particular abuses such as "parking" may be problematic, because of the difficulty in proving that the underwriter had an interest in the "customer" accounts in which the stock was placed.

Our vigorous efforts should be viewed as a commitment by the Commission to devote its resources to emerging problems as they are detected for the benefit of public investors and not as an attempt to reflect adversely on a legitimate sector of American business and enterprise. We are aware of the critical comments made in certain sectors of the marketplace that reflect concern about a stigma being attached to all low price securities because of certain recent unfavorable publicity. While we are sympathetic to that concern, we remain committed to our resolve to correct the abuses we have seen and to deter those who would interfere with efficient and legitimate capital raising mechanism.

Thank you.

TRADING VOLUMES SET NEW PRECEDENTS

Mr. **Shad.** Based on the dollar volume of financings and transactions between August of last year and June of this year, the United States has just witnessed the broadest and strongest stock, bond, and new issue markets in history.

During this period the broad-based stock indices rose approximately 70 percent—that from March of last year to June of this year—on unprecedented trading volume. The volume was absolutely enormous. About a fivefold increase occurred in the trading volume immediately before and after this dramatic bull market.

Since June of this year, the market has been backing and filling, moving sideways. And there have been some bankruptcies. There may have been some bankruptcies of penny stocks but also of Baldwin United and Osborne Computer, and particularly the latter which has been a very hot stock, so to speak.

That has dampened somewhat the new issue market. But it still exceeds all precedents in terms of dollar volume. I will get into that in a moment.

Now, I would like to go to this chart over here and show you where the market has been.

And I don't know the best way to do it. If any of you want to come around to be able to look at this, please do so.

You have as an exhibit at the end of our formal testimony a small edition of this chart.

This takes the market from 1929 through 1983, up to date.

And you can see in 1929 this is the reaction that occurred that we often talk about as being the tremendous crash, but in proportion to where the market has gone in subsequent years, the change is very small.

However, this exhibit is not adjusted for inflation. If you took the inflation factor over the past 53 years, we wouldn't be up at that level by any means.

In this postwar period you've had certain bull market tops. And bull market tops are often characterized by a rapidly rising volume of new issues in the later stages of bull markets.

These bull market tops have come at 4- to 5-year intervals. Actually, most of them have been at 5-year intervals and occasionally a 4- to 6-year interval; 1981, and here we are today. This move is a 70-percent move on the broad-based indices. This is the Dow Jones which, as you know, is a relatively narrow index, only 30 blue chip stocks.

When you look at the S&P 500 and the other broad-based indexes, it's a 70-percent move. And since June of this year the market has been doing this. It has been flat.

Now, set in this scale is the total volume of initial public offerings filed with the SEC. And this is on a logarithmic scale, but by the same years. And you can see what the total volume has done. It's up the last fiscal year, the year ending September 30, which is the SEC's fiscal year. There were 6,100 new issues filed with the SEC during that period.

That's the total number of filings for all financings. And, of that total, 1,900, nearly 2,000 of them, are initial public offerings by the SEC's definition, which is a broader definition than the industry uses. I'll explain that in a moment.

But you can see how the volume of initial public offerings has been very volatile, and has correlated, of course, with the bull market tops in most years.

So during the SEC's fiscal year, which ended on September 30, corporate financing filings increased 40 percent from the prior year to 6,100.

The dollar volume increased 57 percent to a record $243 billion.

Of these filings nearly 2,000, which is the black section at the bottom of the chart, aggregating $57 billion were initial public offerings.

I'd like to explain that the SEC's definition of initial public offerings is much broader than the industry approach to it. And the reason is that we, the Commission, include all new issues including those which result from a merger where a new company is formed in the process and new securities are issued. Of the $57 billion, those amount to $21 billion.

The principal areas that are looked at when you start talking about the new issue market are principally corporate financings, public offerings, registered under S-1, which is one of our required registration statements, or S-18 which is intended for smaller companies.

The equity S-18's amounted to approximately $2 billion is fiscal 1983, whereas the S-1's, which are the larger companies, amounted to $23 billion.

To bring it up to date, these numbers, using the industry's tabulation of initial public offerings, in the first 11 months of this year, through November—in other words, last month—there were 621 initial public offerings aggregating $10.1 billion.

Now, that compares with $1 billion in 1982. So you have 10 times the volume of 1982. And, of course, it's because the bull market began in 1982.

But that $10 billion during the first 11 months of this year is equal to the total for the last 10 years of initial public offerings—by industry standards or definition.

Along with the dollar volume increase, of course, has been a dramatic increase in the number of such offerings. In 1981, which was a hot issue market as indicated on this chart, there were 429. For the first 9 months of this year there were 600. And this calendar year will come in with well over 700 initial public offerings.

I would like to try to put the economic background in perspective. Are we in another excessively strengthened market of financing opportunities? My answer is no, notwithstanding the dramatic rise. And I would like to give the background for that.

The strong securities markets reflect, among others, the following considerations.

Since 1981 the rate of inflation has been reduced by over 60 percent. The prime rate has been reduced by 50 percent. The maximum Federal tax rates on interest, dividends, and capital gains have been reduced by over 25 percent. So that the risk to reward ratio for investors is a lot better as a result primarily of the reduction of inflation.

Some people say that the capital gains tax is a tax on inflation rather than enhanced purchasing power. But the reduction in the capital gains tax rate and the reduction of inflation are a great impetus for this type of move in the market.

GNP GROWTH RATE OF 7.7 PERCENT PHENOMENAL

And also very fundamentally our industrial productivity growth rate has more than quadrupled since 1981. It is now growing at an extraordinary 7.4 percent annual rate and our gross national product at an absolutely phenomenal 7.7 percent annual rate.

Such extraordinary growth rates cannot be sustained. But they clearly signal the economy's improving prospects.

Within the past 12 months the unemployment rate has dropped an exceptional 2½ full percentage points, from 10.7 percent last December to 8.2 percent today.

This year's corporate profits for the year, calendar year 1983, are expected to exceed last year's by 30 percent and the prospects for next year are excellent.

The record volume of financings is strengthening corporate balance sheets and augurs well for future capital goods expenditures to expand and modernize the Nation's production facilities.

The securities markets to date have not been characterized by the speculative excesses of the past bull markets such as in the late 1920's. The present 50 percent margin requirement compares with 10 to 20 percent in the 1920's.

Only a small portion of total bank credit is being used to finance the stock markets today, and publicly owned companies are subject to the SEC's full disclosure requirements which did not exist in the 1920's.

As indicated by this chart, we've had six bull market tops since the end of World War II at approximately 5-year intervals.

In the late stages of these bull markets, initial public offerings have risen to over 40 percent and ranged up to 64 percent of the total number of public offerings.

So in the past——

Senator D'AMATO. I understand there has been a collossal explosion.

One of the questions I am asked is why this committee is suddenly coming forward to deal with something that maybe we should have dealt with in the past.

When we find an area of exploitation where the public is being taken advantage of, considering the dramatic increase in new issues, we are compelled to move and attempt to do something.

Last year there weren't nearly as many initial new public offerings in comparison to this year.

Let me put to you and Mr. Fedders and the enforcement people this question, which I think goes to the heart of the matter.

Under current law, persons barred from associations with broker-dealers may still act as principals in initial public offerings. The only requirement is that the prospectus disclose any violations committed in the last 5 years.

A recent survey by Venture magazine found that in 78 initial public offerings in 1982 and of those public offerings in which stocks were selling at $1 or less, 38 of them, which is almost 49 percent, involved people who were convicted felons, securities violators, targets of securities injunctions, or principals facing serious charges of trading on inside information.

Considering the findings of this survey and some of the work that the Commission has been doing, is it prudent to only require disclosure of past violations by principals and promoters of publicly traded firms or should we consider baring some of these people from acting as principals and promoters?

More protection is needed because very few of the investing public, particularly those investing in penny stocks, ever read these prospectuses.

That's really the nub of it. Are we adequately protecting the investing public?

As you have pointed out, there is an incredible increase in new issues, many of which are legitimate. But 49 percent of the people behind these public offerings have records of securities laws violations. Senator Hawkins and I will be cosponsoring legislation to give the Commission the ability to bar people who have already been barred from the commodities area from acting as broker-dealers.

Would you care to respond to that?

Mr. SHAD. Senator, I would like to start, and Mr. Fedders probably will have comments.

First of all, I don't think that great weight should be put on the Venture article. Two lawyers accounted for the bulk of these financings. They ran a printing press. They changed the names and filed another issue after issue. Two lawyers accounted for a very high portion of the total volume.

When requested to provide a copy of the survey on which that article was based, the managing editor of Venture magazine said it was a scratchpad variety and not available for public distribution.

Senator D'AMATO. What about those two lawyers? Do they have the kind of history indicated with respect to securities laws violations?

Mr. SHAD. Well, the one—the principal one was charged by the SEC with a stock fraud or a question of manipulation in 1978.

However, it was dismissed when he agreed to certain limitations on the sale of the stock involved. So he wasn't actually convicted. But he was investigated and charged, but the final settlement was a dismissal.

Senator D'AMATO. It almost sounds like two lawyers are running a substantial part of the hot issues.

Mr. SHAD. I would say it's much broader than that in terms of the penny stock market.

Senator D'AMATO. That's what we are talking about.

Mr. SHAD. But I don't think you should put great weight on the Venture magazine article.

Senator D'AMATO. Well, forget the Venture magazine article, Mr. Chairman.

Considering the fact that you have a situation which allows those who are convicted felons and securities violators to participate, don't you believe we should have the ability to give the Commission the option to bar them from acting as broker-dealers?

Mr. SHAD. As your proposal relates to the commodities markets, where they have the right to bar people based on our standards it is appropriate to consider a balanced arrangement in that regard.

INVESTORS NEED TO READ PROSPECTUSES

I'm not sure how far we should go in the proposal to bar from being principals in companies anyone who has been accused of a securities law violation. I'd say if we have a fully litigated case and so forth, you may want to put the public on fuller notice, I appreciate the problem is, simply, the public doesn't read prospectuses. But the securities analysts do. The brokers do. The investment advisory services do. The institutions which account for 70 percent of the market do.

And these services are the people that recommend the securities. The responsible brokers and others are sensitive in these areas and they do tell people not to buy.

That is not to say there aren't a lot of unsophisticated individuals that ignore that advice or they simply want to gamble. They go to Las Vegas, or they go to Atlantic City, or they buy penny stocks in some cases.

Senator D'AMATO. Let me ask you this.

Should we consider requiring issuers to disclose convictions of their principal shareholders?

Mr. SHAD. Well, that is an interesting suggestion because it is required in, under the 1934 act, the aftermarket filings of companies—in the case of 13D's, for instance. And yet it is not required in the initial public offerings under S-1 or——

Senator D'AMATO. Supposing a principal stockholder is a convicted felon who has a history and reputation of manipulating market prices; should not the public have the ability to know that information? If someone from one of these companies were going to be getting the bulk, of $3 million—for instance, suppose he has 50 or 60 percent of the equity in the company—shouldn't the public know who it is that is going to be the principal stockholder?

Mr. Fedders.

Mr. FEDDERS. I think there is some merit in what you are suggesting, Senator.

And as Chairman Shad said, under the 1934 act, if a person is a 5-percent shareholder, he has an obligation in his 13D's or other reports to disclose these prior criminal convictions.

And I think there is some merit to it. We will strongly recommend that the Division of Corporation Finance consider that, whether in all 1933 act documents there ought to be similar requirements with regard to principal shareholders or persons who own more than 5 percent.

Senator D'AMATO. That is important particularly as it relates to penny stock and the $2 million or $3 million offerings. That is where the public is most vulnerable.

We are not talking about someone coming out with legitimate offerings. Those are not the problem.

How do we distinguish one from the other?

You had a red flag—let me give Senator Hawkins an opportunity before I go to the area of the red flags, how well we can protect the public.

Senator HAWKINS. Yes.

Whose past violations and convictions must the issuer disclose under the present law?

Mr. SHAD. Ernestine.

Ms. ZIPOY. Generally under the present law violations or convictions of directors, of officers, of anybody who is performing the functions of a director or an executive officer whether or not he bears the title of that; anyone chosen or nominated to become a director. All of these persons in almost all the forms require disclosure of any convictions or of any past civil fines or injunctions.

Senator **Hawkins**. That includes the officers?

Ms. **Zipoy**. Yes; executive officers and directors.

Senator **Hawkins**. But not shareholders?

Ms. **Zipoy**. Unless they have 5 percent under certain circumstances.

Mr. **Fedders**. But it's a different act, Senator. What Ms. Zipoy was addressing was the registration requirements under the 1933 act which addresses directors and officers and has no similar obligation with regard to criminal convictions by principal stockholders.

However, under the Securities and Exchange Act of 1934, there is a requirement with regard to past criminal conduct by 5 percent shareholders or more.

The sense of what I believe Senator D'Amato was recommending is that it's a darn good idea if we take a look at including that obligation under the 1933 act rules for registration.

Senator **Hawkins**. Yes.

Senator **D'Amato**. Let me ask you something.

Would you draft some proposed legislation so that when we get back to dealing with this topic we will have an opportunity to submit this to counsel. I'm planning to offer this as a means of legislative protection.

I think if one has a convicted felon who is wheeling and dealing—and, by the way, let's not forget we have people who have been convicted for a crime and who have been rehabilitated, shouldn't the public have the ability to be informed and protected?

Mr. **Fedders**. Senator, I would suggest this.

With regard to that narrow point that you have addressed, with respect to whether a principal stockholder's past criminal conduct ought to be required disclosure in 1933 act documents, you leave that to the Commission's discretion whether it should be in 1933 act documents.

To do it by legislation would be aberrational because the legislation now doesn't dictate specific information requirements. That has been left to the rulemaking authority of the Commission, of the Division of Corporation Finance. And respectfully I think that is where it belongs.

Senator **D'Amato**. Yes.

Mr. Chairman, do you think that we can get the Commission to consider soon the suggestion that I have made?

Mr. **Shad**. I like it frankly, Senator. I want to compliment you on the suggestion.

We have two acts, one for when somebody sells securities and the other one for the aftermarket.

We have integrated their requirements in most of these areas, but this is one area that in fact has not been integrated. And we certainly will give it a very careful analysis.

And the advantage of the approach that Mr. Fedders is suggesting is it's a lot faster for the Commission to move on a rulemaking basis than legislation.

Senator D'Amato. If you've got that ability to do that by way of your own regulations, then I would suggest——

Mr. Shad. It would be put out for comment, for everybody to respond; the usual procedures.

Senator D'Amato. Senator Hawkins, do you have any further questions?

SURVIVAL RATE FOR NEW ISSUES OF PENNY STOCKS

Senator Hawkins. What is the survival rate for new issues of penny stocks? Do you have that?

Mr. Shad. I can give you the best indices we have. In fact, it's in our long-form testimony on page 12, I believe. The——

Senator Hawkins. You don't have the accurate information?

Mr. Shad. Well, let me tell you what I do have. I think it may satisfy you.

The SEC did a survey in October of this year. We originated a survey a couple of years ago. And the net of it is that 78 percent of the companies that did initial public offerings under S–18, which is the smallest category of companies, 78 percent were still being traded in the marketplace 3 to 4½ years later. They were still in business.

So, expressed the other way, 22 percent have disappeared.

To give you some feeling about that: There were 69 issues, the total volume of S–18 offerings between April 1979 and September 1980. So that was the sample group that was taken.

If you would have put $100 in each one of those companies, the stock—at the time of their initial offerings—that would have been $6,900. Some of those, 22 percent, have disappeared. But notwithstanding that, that investment would now be worth $7,500 or 9.7 percent more than it would have been at the time of those offerings.

So there has been appreciation. To put it in better perspective—the whole market has had a tremendous move since then. And if you had put it into the NASDAQ composite average, you would have an appreciation of 74 percent.

In other words, people sometimes think because it's a penny stock, it's cheap. It's not cheap. The penny stocks have not performed as well as the indexes of all of the current stocks.

But I do think it does point up this fact. We are talking about a very small piece of the total market. And I think that is the important point.

The highly promotional ripoffs, as some people would characterize them, are very small, the companies with no operating records and as some have said, a scheme and a dream or a printing press and an idea they go public with. They represent less than 5 percent, in fact substantially less than 5 percent of the total dollar volume of even initial public offerings. It represents a very small portion of those offerings.

And if you take the $400 million figure that has been mentioned of penny stock offerings this year, I would guess—and this is only a guess—that half of them do have some sort of an operating record. About half of them are straight promotions with no operating record at all.

Let me mention. You know, the company that built the heart that kept the doctor alive in Salt Lake City for 118 days, that company went public. It had a loss of $64,000. It had negligible net worth. They raised $19 million. But it was—it did have some highly sophisticated doctors and engineers to try to build a mechanical heart.

And so—these are highly speculative, but some of them actually make it. Some of them——

Senator **Hawkins**. That's true.

Mr. **Shad**. America has been built on this entrepreneurial spirit, and some do make it.

Senator **Hawkins**. Some do make it but a lot don't make it.

To go back to the article we saw in Venture magazine, it seems to me that a lot of that could have been stopped. You say two lawyers were involved when it was brought to your attention. It seems to me that that should have been pointed out by the SEC at the beginning by having a cross-check, a reference in the computer to see if these names turn up again, and again, and again.

Mr. **Shad**. They make disclosures. You know, they comply with the law.

The problem in this new issue market has not been failure to make full disclosure. The SEC fully reviews these initial public offerings and demands more and more and gives them a lot of problems in compliance. And they comply. So there is not only——

Senator **Hawkins**. Is there adequate diligence on the part of the lawyers?

Mr. **Shad**. Pardon?

Senator **Hawkins**. Is there adequate diligence on the part of the lawyers?

Mr. **Shad**. Well, when you've got a startup——

Senator **Hawkins**. You can buy these forms someplace and just put in your handydandy name and make the print small enough and the pages thick enough until indeed you could have an offering for a shell corporation.

Mr. **Shad**. Well, the amount of due diligence required on a startup company's offering is very little. You don't have much to investigate. And you don't have a historical operating record. You don't have financial statements. You don't have anything.

And so I would not be able to say, you know, that I believe we have a valid cause of action on that type of promotion because of lack of due diligence. The amount of due diligence is intended to investigate an ongoing company's problems.

Mr. **Fedders**. Senator Hawkins, one thing that—I've reviewed an enormous number of these prospectuses in the past year. And the overwhelming majority have full and adequate disclosure.

And it points up something that Chairman Shad said earlier, people simply don't take the time to read them and digest them.

The real problems that I think the Venture magazine article did point up is not disclosure, but underwriting conduct or underwriting misconduct and aftermarket abuses, the hyping of the stock, tie-in arrangements, wooden tickets and things of that nature which are laid out in very good detail in the chairman's and my statement.

SEC'S PROBLEM WITH AFTERMARKET CONDUCT

We are really worried about aftermarket conduct. If you want to know the pressures that I feel and my colleagues on the right and left of me from an enforcement point of view, it is not so much uncovering disclosure fraud, but it is finding the relevant investor to come forward to help us prove these underwriting misconducts, the aftermarket abuses, and the hyping of the market in what we call garden variety manipulation.

Senator D'AMATO. I think they don't have to engage in fraud. They can tell you right there. We've never run a business. We don't even have a plan. All we're going to tell you is we are not going to invest in oil and gas. So why would someone commit a fraud? It would be silly. But you're not going——

Mr. SHAD. The disclosure——

Senator D'AMATO. Well, the problem is not with the disclosures in the prospectus. It points out how impotent we are. We're impotent. Someone tells you "I don't even have a plan. And don't ask me." This is incredible—the company has no plan of operation and can provide the investor with no information whatsoever as to its intentions.

Mr. FEDDERS. Senator, I should point out to you——

Senator D'AMATO. Now, let me ask you something. It's going to drive everybody absolutely crazy.

Do you think we need to have some regulations regarding merit review? Do you really think we should allow a prospectus that can merely say the issuers have no plan and are not going to tell you that they have anything? Should we allow that to take place?

Mr. FEDDERS. Two things, Senator.

First of all, one of the prospectuses that you have been talking about is something called a "blind pool arrangement." And in those kinds of arrangements it is not required, and the Commission does not mandate, that the promoters come forward and describe where they are going. It simply describes, as that prospectus does in some 40 or 50 pages, some various arrangements.

But I would tell you from my experience both within and out of the Government that I don't think the Federal Government has the capability, the ingenuity, or any business in merit regulation.

And I would be a strong opponent of any suggestion that the Federal Government has the ability to get in and make for its citizens determinations whether or not a particular security ought to be sold.

I'd take my shoe off and pound on the table and tell you that these people ought to read, read, and read—understand what is in the prospectus.

Senator D'AMATO. Let's talk about that red flag you were talking about—the warnings that could save lots of people lots of embarrassment. Although some people invest with rather modest sums, to them it might be a large percentage of their net worth.

How could you arrange it so that the general public would get the information, the so-called red flags, in order that they may pursue either the broker-dealer, or the market, or whether it's prior to their purchases, those things they should be alert to and what they should do.

Is there any way that the SEC could send a copy of the red flags to the public? If so, would you tell us how and where and what you would advise?

Would you be willing to put out that one-page list or two-page list of warnings so that the average person—not the sophisticated investor on the street—may be protected?

Mr. **Shad**. Well, you know, I started off by complimenting you on these timely hearings. We handed this out to all of the press here today, and I would hope they would run a sidebar on any stories setting forth these red flags.

The best way we can get it out to the investigating public is through hearings such as this, through the public media.

It would be—there are 42 million investors in America. How could we effectively get the message out?

I think that it is much better when it comes with a story that puts the magnitude of this market and the problems that are posed in perspective and then runs it through——

Senator D'**Amato**. You have a lot of investing public who are unsophisticated and who do not read the Wall Street Journal and do not read the business section of the New York Times. We're lucky if we even get a little blip in there about the hearing, let alone a sidebar telling them about the red flags and what to do.

That's a challenge.

But, you know, I don't believe it. If we do, fine. And I'm not going to say I'm not interested. Obviously I think that we should attempt to develop public awareness.

For those people who request information with respect to what to look forward to or the red flags, and they are—is there some way they can contact or write to a particular address and so that the SEC can send them the information? We are not going to say you are going to send it out to 42 million investors, most of whom wouldn't want it, but rather to those unsophisticated investors who request it. Is there a place they can write to or be heard and get that information?

Mr. **Fedders**. Some of the investor digests that reach small investors I'm going to personally encourage to run these red flags as well as letting them know if citizens want to write in and receive Chairman Shad's and my written testimony of today and the red flags, we would be prepared to——

Senator D'**Amato**. Don't send your testimony to the average person. Just tell them about the red flags. Is there a place that they can write to——

Mr. **Fedders**. Sure. They can write to me at the Commission and we'll send the red flags out without the 32 pages.

Senator D'**Amato**. Now, where would they write to?

Mr. **Fedders**. They would write to John Fedders——

Senator D'**Amato**. Tell them.

Mr. **Fedders** [continuing]. Securities and Exchange Commission, Washington, D.C. 20549.

Senator D'**Amato**. As Chief Enforcement Officer?

Mr. **Fedders**. Sure. They can use that if they want. I think people know——

Mr. **Shad**. The information law——

Senator D'**Amato**. They don't know. You think the little old lady in Brooklyn who has invested knows that John Fedders is with the SEC and is an enforcement officer?

Mr. **Fedders**. She called me yesterday. [Laughter.]

Senator D'AMATO. Please go ahead.

Mr. SHAD. Well, I would also say the NASD would be a source, Senator.

On complaints, for instance, the direct oversight of the broker-dealer community of over-the-counter brokers—is under the National Association of Securities Dealers. You will be hearing from Gordon Macklin.

SEC'S ENFORCEMENT PROGRAM WITH THE HOT ISSUE MARKET

Senator D'AMATO. I'm going to ask them what their recommendations are as well.

Would you outline the level of the SEC's commitment in terms of examining attorneys, personnel, the SEC's work on an enforcement program dealing with the hot issue market, and then describe your current efforts dealing with these issues, and what can and should be done.

Mr. SHAD. It's a major area of the Commission's staff responsibility.

It involves the review of all of the initial public offerings that are filed with the SEC.

Senator D'AMATO. What kind of activity are you concerned about after the initial public offerings?

Mr. SHAD. All right.

A very dramatic effort this year, in 1983, has been a task force in New York consisting of 25 members of the New York regional office of the SEC, plus 4 from our headquarters in Washington, plus a group from the National Association of Securities Dealers, a total of over 38 people, 25 of them full-time. On one day this task group moved into 9 firms that have been active in this segment of the market, to get into their specific records, functions, and their sales practices in particular.

That was a task group. But you know, task groups are very dramatic. But also the fundamental is the ongoing pervasive effort in reviewing what's going on in this market which is being done all the time.

Senator D'AMATO. In fact, you've indicated that you have made this a major commitment with the assignment of such personnel to this area.

Mr. SHAD. That's right.

Senator D'AMATO. To what extent have you coordinated your efforts with the U.S. Attorney's Office?

Mr. SHAD. We do work very closely with the U.S. Attorney's Office, and that is under Mr. Fedders.

Mr. FEDDERS. Senator, we at the home office meet with the Department of Justice Fraud Unit on a monthly basis, and each of the 15 regional administrators and branch office heads out in the field meets with the local U.S. Attorney's Office on almost a monthly basis to coordinate—tell them what our inventory of cases are.

We've alerted the Department of Justice to special problems in the hot issue market. As much as we can do is to enjoin people, sometimes get restitution in the form of disgorgement. However, one or two criminal prosecutions of hot issue violators could have a tremendous effect at this time.

We told Rudy Giuliani—I spoke to the folks in his office as early as 2 days ago about the problems in the hot issue market. They were very much aware—I think that this hearing is going to put pressure on the Securities and Exchange Commission to produce and on the U.S. attorneys around the country to produce in this area.

And I like that pressure, and we'll be responsive to it.

Senator D'Amato. We're interested in the kind of business in which the broker-dealer says, "Look, you don't sell now, you know, hold on, I want you to reinvest, I want you to buy this one;" is this the kind of thing we're looking at?

Mr. Fedders. Those are the kinds of things we are looking at the Commission level with our task group in New York headed by Don Malawsky to my right. There is an enormous amount of pressure——

Senator D'Amato. He's good.

Mr. Fedders. He's very good.

And there is an enormous amount of pressure on him. And I want to increase that pressure, and I'm glad you're here today to witness the increase in pressure.

Senator D'Amato. Do you have enough staff in that area?

Mr. Malawsky. Senator, we have planned this particular project with the firms involved. I feel at this point we had enough staff to do the examinations.

Getting into the investigation——

Senator D'Amato. Has NASD been helping you?

Mr. Malawsky. And NASD did an enormous job, and we worked very closely with them, and I think——

Senator D'Amato. That is important to know. Ninety-nine percent of the industry wants to deal with this in a manner that protects the integrity of the industry.

Mr. Shad. That's right.

Mr. Fedders. I think that is a good point. On another score, Senator, we are today casting aspersions on a very small segment of the hot issue market.

Remember, there is a lot of small entrepreneurs out there that are going about the marketing of their securities and an awful lot of——

Senator D'Amato. I'm going to come back to one thing.

I can't believe in good conscience, that today, the people who put this out really say, "We have no company, we don't have any information, we never did and we're not going to tell you what we are going to do."

I don't know who the underwriter is. I'm not going to get into it. But I'll tell you that it smells. That comes from my own sense of it. That is incredible.

Mr. Shad. Senator, I would try to—I agree with you. But—I want to amplify that.

When you're in the euphoric stage of a hot new issue market, individuals abandon normal caution and, in fact, a lot of them have done very well. They get to the greater fool theory of the marketplace which is—I think it's ridiculous. I have looked at the prospectus. It's not worth what they are asking for this stock.

But, an investor may think a greater fool is going to pay a higher price for it tomorrow.

Senator D'Amato. I see some of the examples you have in your testimony.

One company, which was organized to sell medical equipment, issued 39 million shares at 1½ cents per share, disclosed that the principal shareholder and vice president was an unemployed 21 year old, who intended to devote 10 percent of his time to the company. Maybe they're lucky. If he spent more time, they would be in real trouble. [Laughter.]

Two others intended to devote 3 percent of their time to the company. The company was incorporated 2 months prior to the filing of the registration statement and had no operating history.

This is worse—it's like a carnival, when someone says, "Come and try to knock over the bottles." He may have a chance of knocking them all over.

This is incredible.

ADEQUATE ENFORCEMENT PERSONNEL

But I think it is the kind of careful coordinated effort between legitimate brokers, the NASDAQ people, between the SEC enforcement personnel—what about personnel? Do you have enough?

Mr. **Fedders.** We think we do, Senator.

To begin again, Senator, for the benefit of the stenographer, we think we do have enough staff right now. There is a lot of pressure on us and I don't want to minimize that pressure.

In 1982, the fiscal year, we increased our production of cases by 30 percent with a 6-percent reduction in staff.

Last year we had a very minimum reduction in staff and we were up another 3 or 4 points. We had 261 enforcement actions in fiscal year 1983 compared to 254 the prior year.

I don't know that we can achieve that number and I'm not strictly on a quantity basis——

Senator **D'Amato.** No.

Mr. **Fedders.** The quality of our cases is very important, and the quality is very good at the present time.

We can't continue to do more with less. I don't suggest that you continue to cut our staff in order to increase our quantity and quality. But we have a good presence. We have a visibility. At the present time the thing that is most satisfying to me about the enforcement program is the breadth of the program and the presence of the program.

Now, there is pressure on us to be as productive with quality cases in fiscal year 1984. And I think with the quality of the individuals that we have on the staff, that we can be successful.

But that doesn't necessarily mean the number will be the same. But one thing I guarantee you, the quality of our cases in the next 10 months will be Tiffany.

Senator **D'Amato.** As a wrapup question—maybe some of the people in the enforcement area might even be able to answer this—what about the willingness of the victims to cooperate as you investigate and become involved in this area? Do they cooperate? Are they fearful because of ridicule or any other thing? Or do you find them semicooperative or is it difficult to get them to come forward and give you information?

Mr. **Shad.** During the euphoric stage of a hot new issue market, it's very difficult to get the investing public to cooperate.

Once the market—once the bubble bursts and people have huge losses—and a lot of them will sustain big losses—then they're cooperative. Then they come forward and volunteer.

Senator D'AMATO. Do you mean, the old thing about the bid and the stock went up $5 today and $10 tomorrow and on and on and on, and finally the investor says "I want to sell" and there is no one to buy?

Mr. SHAD. To whom?

Senator D'AMATO. Have you begun to get any of these kinds of situations and are the investors cooperative?

Mr. FEDDERS. The volume of complaints in the hot issue market at the present time is less than I would have expected. But remember we are still in the euphoric stage of it. We are investigating a lot. We are looking at a lot of aftermarket conduct and underwriting misconduct.

Remember the psychological point of some of these investors.

First of all, they are embarrassed personally because they consider their own conduct foolish and question whether it was illegal in some circumstances.

Others continue to want to participate in the hot issue market. And the fear is if they come forward and testify against their broker, is that that broker will not provide them access into the hot issue stocks of the future.

And what they are concerned about is that the SEC is not as great a source for restitution as participating in future hot issues that might be productive.

So you would be surprised in some circumstances, even though we believe there was misconduct, proving it in a court of law is another thing. And we have great difficulty in getting witnesses to come forward.

Senator D'AMATO. Let me thank the Chairman for giving his time in this area.

Are there any other observations that you, or Mr. Fedders, or anyone else thinks that this committee should have for the record before we move on to our next panel?

Mr. SHAD. I think that you have identified the important areas for us to go to work and be responsive.

Senator D'AMATO. I certainly like to think that at least in terms of the one legislative proposal, which would permit the SEC to bar from participating in the securities industry those who have already been barred from the commodities industry that you at least have that discretion and ability to deal with that.

And second, the Commission itself may undertake the rulemaking which would provide disclosure so that, at least, one may find out if there is a company that said "We're not going to tell you what we are going to do, all we're going to tell you is what we are not going to do," and that if some of the principal stockholders have been convicted of felonies and are not above taking whatever moneys come in and using them for their own purposes and really using this as a legal tool to accomplish this end, the investing public may be given that information which relates to their past criminal conduct.

I'm very much encouraged by the Commission's response that you would be willing to undertake that. At least the public should have that kind of knowledge made available for those few who read the prospectus.

DISCRETION AUTHORITY NEEDED BY SEC

Mr. **Fedders**. On your legislative proposal where a person—if the legislation which you are suggesting would be enacted—would be barred from the securities industry by reason of a bar in the commodities industry, I would recommend that you not make that mandatory that the person be barred, but at least leave it discretionary, that the Commission in its discretion, can exercise its discretion, could bar the person from the securities industry based on a previous commodities violation.

But I would encourage you not to make it mandatory.

Senator **D'Amato**. Let me suggest to you that that is exactly my intention. There is a rehabilitative aspect. I'm not going to be prejudging those of you in the field who have the sources to determine whether or not a person should be allowed to come into an industry under certain conditions you might want to impose.

You would have the ability to impose certain conditions.

I would be interested in your also drafting that. We have drafted it. I'm pretty sure we can get the Banking Committee to poll this out rather quickly after we leave here and go back to Washington.

And I look forward to your cooperation.

Let me thank the Chairman, our Chief Enforcement Officer, those who are not in the field, and staff of the SEC, for their participation today.

I'm deeply appreciative.

And we will take just a 2-minute break while the second panel comes forward.

Mr. **Shad**. Thank you, Senator.

Mr. **Fedders**. Thank you, Senator.

[There was a brief recess in the proceedings.]

Senator **D'Amato**. Let me welcome the second panel. Thank you for your participation.

Obviously the Commission has indicated the work of the NASD in helping to police this area has been invaluable.

So, I commend you for your efforts, and let me thank you for participating today.

Mr. **Macklin**. Thank you, Senator.

STATEMENT OF GORDON MACKLIN, PRESIDENT OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, ACCOMPANIED BY JOHN E. PINTO, VICE PRESIDENT, SURVEILLANCE, NASD, AND FRANK J. WILSON, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, NASD

Mr. **Macklin**. I'm Gordon Macklin, president of the National Association of Securities Dealers.

And with me today are Frank Wilson, executive vice president and general counsel, and John Pinto, our vice president of surveillance.

Chairman Shad said we do work closely with the Commission although we are an industry-financed organization. And we've had a close working relationship both in enforcement and in policy development matters for decades.

We have provided the subcommittee with a detailed written statement. I would like to highlight.

Senator D'AMATO. Let me suggest to you that the entire statement will be accepted into the record as if read in its entirety and you might want to highlight parts of it.

Mr. MACKLIN. That is excellent.

Our organization, NASD's purpose is to provide self-regulation of the over-the-counter securities market.

And in doing that, in addition to hundreds of committee people involved, we have a staff of over 1,000 people to achieve our purposes.

At this time the NASD has broker-dealer members employing over 250,000 salespersons and we carry out our examination, disciplinary and regulatory responsibilities through our Washington headquarters and 14 district offices located in major cities throughout the country.

OVERVIEW OF NASDAQ COMMUNICATION SYSTEM

In addition, the association maintains and operates the NASDAQ automated quotation system. This system, which revolutionized the over-the-counter marketplace in 1971, provides up to the second quotations for qualified over-the-counter securities for professionals and investors by way of the nationwide NASDAQ communication system.

Share volume of NASDAQ is second only to that on the New York Stock Exchange. In dollar volume NASDAQ ranks third among world markets.

At the present time there are in excess of 3,500 securities quoted in the NASDAQ system and an additional 633 in the NASDAQ/national market system for which the system records not only quotations but last sale price transactions.

As set forth in your invitation to testify the subcommittee seeks to determine whether a problem exists in the hot issue market; and if so, whether it relates to disclosure or manipulation, and further what the NASD and the SEC are doing to address the problem.

The ultimate goal, we gather, is for you to determine whether some sort of additional legislative relief is warranted.

At the outset we hope you'll note that the current hot issue market is not a new phenomenon, but a recurrent one which has been the focus of study from as early as 1946 through the time of the "Special Study of the Securities Markets" in the early 1960's, again in the late 1960's, again in the early 1970's, and again, as Senator Hawkins mentioned, most recently in the 1980–81 Denver hot issue market which really was more traditional, more typical of the traditional hot issue market than the one which is occurring at this time.

For example, in 1981 of the 134 initial public offerings of securities which traded at a premium in the secondary market, all of which were closely scrutinized by our routine surveillance and regulatory programs, 86 or 64 percent were issues with a public offering price of under $5 a share; 52 of these 86 sold for $1 or under when initially offered to the public.

In addition, 67 of the 134 hot offerings had 25 or fewer broker-dealers participating in the distribution and over 20 of those involved 10 participants or less.

In contrast, thus far in 1983, 126 new offerings have traded at a premium in the secondary market. However, only 16 or 13 percent of the 126 issues were priced at less than $5 per share. Ninety-two issues, or 73 percent, had offerings prices in the $5 to $20 range, and 14 percent were priced in excess of $20.

Further, 80, or 63 percent, of the 126 offerings involved large nationwide syndicates where in excess of 50 broker-dealer participants were involved in the public distribution.

A market such as the one in 1981 is far more susceptible to manipulative abuses than the current market because of the relatively low prices of the issues and the substantial concentration of the shares among few broker-dealers and their customers.

Investigations into the activities in the Denver market by the NASD and the SEC revealed the use of such tehniques as tie-in sales, where customers would be required to purchase "cold" new issues or other issues in the aftermarket in order to obtain allocations of hot issues, commission schedules involving large payouts for sales of favored stocks while providing little or no compensation for liquidations of those securities, delays in certificate delivery making it difficult for customers to rapidly liquidate their positions, and the use of nominee and other controlled accounts as a means for retaining control of the market.

Even hot issue markets unrelated to general market performance, however, tend to develop a momentum of their own so that improper sales practices and activities by professionals which may have been utilized to engender initial interest in the issues may be less necessary as the market progresses.

I think Chairman Shad said, these markets have a tendency to feed on themselves until the cold wind of economics ultimately catches up with them.

When the Denver market declined, as do all of the hot issue markets, the NASD and the SEC during February and March of 1982 combined in a joint task force in a massive 3-week effort to conduct special financial and operational examinations of 41 firms in the Denver area to determine the effect the decline had on the firms and their customers.

These examinations disclosed financial and operating problems of varying degrees of severity in 21 of the 41 firms, and 9 of the firms were referred to the Securities Investor Protection Corp. as in or approaching financial difficulty.

Most of the firms agreed with the NASD's recommendations to take corrective action through restrictions on their scope and type of activity. Ten firms went out of business. However, only three required that a SPIC trustee be appointed. The remaining seven firms were self-liquidated. There was no loss to customers or other broker-dealers or the SPIC fund.

Offerings such as those seen in 1983 resulted in a more widespread distribution to a broader-based investor universe of issues of companies which are more substantial in nature.

Such a market is much less susceptible to manipulating abuses in that it is far more difficult for any one individual or firm to dominate or control the marketplace.

Notwithstanding this fact, we are undertaking investigations in a number of areas to analyze sales practices and other elements of broker-dealer participation in the distribution of hot issues. The purpose of these investigations is to learn if, perhaps, new practices have developed in this market which, although different, may require regulatory action. There are some indications that this may be the case.

You asked in your invitation whether problems in the hot issue market related to disclosure or manipulation. Not all problems which arise in the context of a hot issue market can be categorized in either of these terms. Abuses of a manipulative nature certainly can occur and are being addressed by the regulatory authorities.

We realize we do not have a responsibility to routinely review new issues with respect to disclosure made in the prospectus. This is the province of the SEC. We have noted, however, during investigations and in bringing disciplinary actions against members or individuals involving hot issues, including the low-priced hot issue, that there generally appears to be substantial disclosure of the risk factors of the offerings including the lack of financial strength of the issuer, the questionable nature of its business plan or the lack of a product and the regulatory history of participants, as you so wisely said. These are available for the investor to see in the prospectus.

FREE-RIDING AND WITHDRAWAL

One problem which can affect all hot issues and which does not necessarily contitute a disclosure or manipulation problem is that of free-riding and withholding; that is, allocating shares to favored customers or retaining the shares in the firm or a controlled account. This is an area in which the NASD has the primary enforcement responsibility.

And the failure to make an actual public distribution of the securities constitutes a sufficiently serious impairment of the marketplace to warrant a proscription of the practices even without evidence of manipulation.

The NASD has had an interpretation with respect to free-riding and withholding as a part of its "Rules of Fair Practice" since 1950.

This interpretation today contains either absolute or conditional prohibitions on the sale of hot issues in eight different categories of accounts, primarily focusing on broker-dealers, insiders, and certain institutional accounts from which the broker-dealer may wish to curry favor.

The association's free-riding program requires that every public offering of securities underwritten by NASD members be reviewed.

Those issues which the association determines traded at premiums above the public offering price are made the subject of questionnaires which are issued to all underwriters and selling group members. Completed questionnaires are then returned to our office for review and restricted sales are referred to the district.

During the period from January 1983 through November, a total of 7,367 questionnaires were forwarded to members in the review of 126 public offerings that went to an initial premium in the market and 75 disciplinary actions have been initiated.

Another aspect of the association's regulatory program that monitors activity in new issues as well as trading in all NASDAQ securities is its market surveillance section.

This activity embodies a fully automated market surveillance system which combines state-of-the-art technological resources of the NASDAQ system with surveillance procedures aimed at deterring a variety of potential abuses.

We have a significant investment in our market surveillance area. We would be delighted to discuss that if you are so interested.

A complement to the online stockwatch program is the market information data access system, the acronym in-house is MIDAS. This online computerized system provides instantaneous access to 60 days of market quotations in any NASDAQ security by any marketmaker timed to the second and identified by the serial number of the quotation machine.

These online systems as well as 15 off-line systems which are in place are invaluable to the association staff. We call the online system our instant replay machine.

A further aspect of the association's regulatory framework for dealing with the issues are the 14 district offices referenced earlier.

Briefly, routine and special examinations are conducted according to examination cycle by 235 examiners located throughout the country. This is a force that has been expanded by about 30 percent in the past few years.

Examinations include a review of new issue activities, such as hot issues, and distribution practices for possible manipulative activity.

In addition to the onsite examinations conducted by the district offices' examiners, the association also has an antifraud unit to deal with abuses in the hot issue market among other fraudulent activities.

This unit, which is comprised of experienced senior staff members is available to supplement the activities of the districts in pursuing complex cases involving apparent substantial abuses.

Over the years the association through its antifraud unit has conducted a number of joint investigations with the SEC and various State securities' departments.

At the present time the NASD is engaged in joint examinations with the SEC on a number of matters involving new issues in various parts of the country.

In addition, our antifraud unit is involved in its own investigations.

These investigations into the hot issue market of 1983 are still open and under active review. Upon completion of these investigations either the SEC or the NASD will bring disciplinary proceedings if the suspected violative activity can be documented.

The ultimate objective of the committee is a determination of the need for legislation to address abuses which may exist in the cyclical hot issues.

We believe that existing provisions, such as the free-riding and withholding interpretation, the antifraud provisions of the securities law and the rules and regulations thereunder do provide a substantial base for regulating improper activities with respect to hot issues in the same manner as they do for other aspects of the securities business, and that unless the ongoing investigations into the hot issue market reveal facts which would indicate this is no longer going to be the case, we don't have any specific legislative provisions.

We do, as you mentioned earlier, as a member-owned and member-controlled organization, have a significant stake in a clean market. We know from experience that this country, investors and indeed our members are better served by clean markets. And we are certainly anxious to help.

Senator D'AMATO. We thank you very much for your time and for coming to testify on this issue.

What is your opinion of the proposal that would permit the SEC to bar from the securities industry those people who have been barred or suspended from the commodities industry?

Do you think that the SEC should have that authority?

Mr. MACKLIN. I think—the first time I heard that proposal was this morning, I think it has a considerable amount of merit. It's symmetrical with what the commodities people can do, and I think it would be very helpful.

Senator D'AMATO. What is your opinion with respect to the SEC requiring the issuers to list their past securities violations as well as the felonies of major stockholders?

Mr. MACKLIN. Well, that suggestion too is well along the lines of the spirit of adequate disclosure as we would see it. I think there is considerable agreement to that too.

Senator D'AMATO. I don't know if any of your colleagues care to respond to that question.

Mr. MACKLIN. We consulted while it was under discussion with the last panel and I think we are unanimous.

Senator D'AMATO. What are the listing requirements for NASDAQ?

NASDAQ IS A THREE-TIER SYSTEM

Mr. MACKLIN. Well, NASDAQ, in terms of companies involved, is really a three-tier system.

We have basic listing requirements which must be met for inclusion in the system.

Then we have a significantly higher set of requirements for inclusion in our daily newspaper list.

And then there is yet a different set of requirements for that section of our newspaper list that is designated the NASDAQ National Market.

Senator D'AMATO. So that NASDAQ National Market we see in the newspapers such as the Wall Street Journal and the New York Times does not take in all of those companies that you have sanctioned?

Mr. MACKLIN. That's correct.

Senator D'AMATO. Each one has a high profile.

We were looking to see the status of the stock of Lezak, L-e-z-a-k, Group, Inc.

Could you let me know that if it is trading, what it is trading at? I would be interested in finding out what that stock is trading at.

Mr. PINTO. The Lezak A common stock has a current quarter bid at five——

Senator D'AMATO. What is that?

Mr. **Pinto**. It's a quarter bid, five/sixteenths.

Senator D'**Amato**. A quarter? 25 cents?

Mr. **Pinto**. A 25 cent bid and——

Senator D'**Amato**. And what did it come out at?

Mr. **Pinto**. I don't know what the public offering was. I know it came to NASDAQ——

Senator D'**Amato**. $5.

Mr. **Pinto** [continuing]. In July of 1983. I think that might have been the unit's offering.

Senator D'**Amato**. Price per unit $5.

Mr. **Pinto**. That's the unit. The unit is quoted at 5 bid today.

The market on the unit is 5/5¾. That came on the system in July also and has traded as high as 6½ and is currently bid at 5.

Senator D'**Amato**. So essentially it's about the same?

Mr. **Pinto**. Since it's come on the system. It's only been on NASDAQ since July. But the range has been between 5 and 6½.

Senator D'**Amato**. I'm going to watch that company.

How would I find out? It's not in the newspaper.

Mr. **Macklin**. We do—let me show you the difference in criteria for basic admission in NASDAQ versus admission in the newspaper list because our newspaper list does offer some degree of investor protection by its very sorting process.

For basic admission in NASDAQ you need total assets of $2 million, capital and surplus of $1 million, and a public float of 100,000 shares.

To be in the national newspaper list, if you have earnings, you must have $300,000 in net income in the latest or 2 of the 3 last fiscal years. You must have a public float of 350,000 shares. You must have a market value of the float at $2 million. You must have a minimum bid price of $3.

And if you don't have earnings, you must have capital and surplus of $8 million. You must have an operating history of 4 years. You must have a public float of 800,000 shares. And you must have a market value float of $8 million.

So——

Senator D'**Amato**. The greater exposure you give them, the greater the requirements, such as financial stability.

Mr. **Macklin**. That is exactly right. There is a considerable qualitative filter related to exposure.

Senator D'**Amato**. If I wanted to find out what they're currently doing because now they are in business, how would I find out?

Mr. **Macklin**. Well, if they are in NASDAQ——

Senator D'**Amato**. Well, they're not.

We looked and they are not printed.

Mr. **Macklin**. They may be in the system. If they are in the system but not in the newspaper you could get a quotation from anyone—from any securities salesman or any investor that has a desk-top quotation terminal.

The price of every security in the system is available at the touch of a button on over 100,000 electronic retail devices located throughout the world.

So you can follow it through.

Mr. **Pinto**. The Lezak group class A and the unit both are quoted on NASDAQ.

Mr. **Macklin**. We went through that Venture article——

Senator D'**Amato**. Can you find out now what they are doing?

Mr. **Pinto**. The price?

Senator D'**Amato**. No, no. I mean—they didn't know what they were going to do. And they could take that money and put it into some kind of Government security and make 10 percent and report profits and given this—you know, you can move garbage for so long.

How do I find out what business they are doing now?

Mr. **Macklin**. They do have to make regular quarterly and annual filings with both the SEC and the NASD. And those filings describe any material change in business.

Of course, they also have their required reports to shareholders.

Senator D'**Amato**. So, since July they have filed one quarterly report.

Mr. **Macklin**. I would assume.

Senator D'**Amato**. Would that be right?

Mr. **Pinto**. I couldn't say. I'm not sure what their fiscal——

Senator D'**Amato**. Wouldn't they be required to file one quarterly report with both NASDAQ and the SEC?

Mr. **Pinto**. They should have.

Senator D'**Amato**. Most of the time I have a list of these questions they ask me. I don't ask them because I don't understand them. I don't have those questions. This is my question.

You told me that they are generally required to file quarterly reports with the SEC and NASDAQ. I'm asking you have they done so.

Mr. **Wilson**. I can't answer whether they have done so. There is a period of time after the end of the quarter within which they must file. I forget right now what that period is. I think it's 45 days. I'm not certain.

Senator D'**Amato**. This will probably turn out to be one of the greatest stocks of all times, the one I'm zeroing in on. You know, it will probably go through the ceiling.

But notwithstanding that, I'd like to really know what business they are in now.

Could you furnish this committee——

Mr. **Macklin**. We certainly can. Their quarterly and annual filings are a matter of public record. We'd be happy to send you a copy.

[The following information was subsequently submitted for the record:]

[illegible]

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

CDP 11-15-83

For the quarter ended September 30, 1983 Commission file number 2-82508

LEZAK GROUP, INC.
(Exact name of Registrant as specified in its charter)

Nevada	95-850418
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
23501 Park Sorrento - Suite 104, Calabasas, California	91302
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (213) 992-8807

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

As of October 31, 1983, the issued and outstanding shares of the issuer's common stock were as follows:

Class	Shares Outstanding
Class A, $.01 par value	16,950,000
Class B, $.001 par value	5,000,000

Total number of sequentially numbered pages in this document: 8.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LEZAK GROUP, INC.
(A Development Stage Enterprise)

CONDENSED UNAUDITED BALANCE SHEET

ASSETS

	September 30, 1983	June 30, 1983
Current Assets:		
Cash	$2,604,901	$3,206,776
Accounts and notes receivable from related parties	117,996	46,202
Prepaid expenses	50,000	
Total current assets	2,772,897	3,252,978
Property, Plant and Equipment, at cost	18,841	18,387
Less accumulated depreciation	(1,836)	(918)
	17,005	17,469
Investment in common stock of affiliated company	60,000	
	$2,849,902	$3,270,447

See accompanying notes to condensed unaudited financial statements.

LEZAK GROUP, INC.
(A Development Stage Enterprise)

CONDENSED UNAUDITED BALANCE SHEET

LIABILITIES AND SHAREHOLDERS' EQUITY

	September 30, 1983	June 30, 1983
Current Liabilities:		
Accounts payable and accrued liabilities	$ 49,690	$ 453,481
Current portion of note payable	3,600	3,600
Total current liabilities	53,290	457,081
Note payable, secured, less current portion	13,353	14,278
Shareholders' Equity:		
Class A common stock, $.01 par value, 150,000,000 shares authorized, 16,950,000 shares and 16,550,000 shares issued and outstanding at September 30, 1983 and June 30, 1983, respectively	169,500	165,500
Class B common stock, $.001 par value, 5,000,000 shares authorized, issued and outstanding	5,000	5,000
Capital in excess of par	2,797,621	2,751,621
Deficit accumulated during development stage	(188,862)	(123,033)
	2,783,259	2,799,088
	$2,849,902	$3,270,447

See accompanying notes to condensed unaudited financial statements.

LEZAK GROUP, INC.
(A Development Stage Enterprise)

CONDENSED UNAUDITED STATEMENT OF OPERATIONS

For the Three Months Ended September 30, 1983

REVENUES:	
Interest	$ 50,344
COSTS AND EXPENSES:	
General and administrative	114,690
Depreciation	918
Interest	565
	116,173
Net loss	$ (65,829)
Net loss per share of common stock	$ (.003)
Weighted average number of shares of common stock outstanding	21,750,000

See accompanying notes to condensed unaudited financial statements.

LEZAK GROUP, INC.
(A Development Stage Enterprise)

CONDENSED UNAUDITED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the Three Months Ended September 30, 1983

SOURCE OF FUNDS:	
Net loss	$(65,829)
Deduct items not affecting working capital - Depreciation	918
Working capital used in operations	(64,911)
Issuance of common stock for legal services to be rendered	50,000
Decrease in working capital	76,290
	$ 61,379
USE OF FUNDS:	
Additions to property, plant and equipment	$ 454
Payments on note payable	925
Investment in common stock of affiliated company	60,000
	$ 61,379

See accompanying notes to condensed unaudited financial statements.

LEZAK GROUP, INC.
(A Development Stage Enterprise)

NOTES TO CONDENSED UNAUDITED FINANCIAL STATEMENTS

September 30, 1983

1. Comments

In the opinion of the Company, the accompanying condensed unaudited financial statements contain all adjustments, consisting of only normal recurring accruals, necessary to present fairly the financial position as of September 30, 1983, and the results of operations and changes in financial position for the three months then ended.

As the Company is a development stage enterprise, the results of operations for the three months ended September 30, 1983, are not necessarily indicative of the results to be expected for the full fiscal year ending June 30, 1984.

2. Net Loss Per Share

Net loss per share is calculated using the weighted average number of common shares issued and outstanding. Common share equivalents are not considered as their effect is antidilutive.

3. Public Offering of Common Stock and Warrants

On July 15, 1983, the Company completed an offering of its common stock and warrants to the public, which provided proceeds to the Company of $3,000,000 less offering costs of $538,009. The accompanying balance sheet at June 30, 1983 gives effect to the public offering and includes the gross proceeds and related accrued liabilities (costs of offering).

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

For the Three Months Ended September 30, 1983

Financial Condition and Results of Operations:

The three months ended September 30, 1983, reflected only limited activity. The Company concentrated on preparing a public offering of its securities, which was completed on July 15, 1983, and which provided net cash proceeds to the Company of $2,461,991. The Company has not begun the acquisition and development of an operating asset base.

Results of operations prior to June 30, 1983 were not significant.

PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits - None.

(b) Reports on Form 8-K:

(1) September 12, 1983 - Establishment of June 30 fiscal year-end.

(2) September 13, 1983 - Agreement in principal to acquire Kennedy-Carter Corporation.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed ~~on its~~ behalf by the undersigned thereunto duly authorized.

LEZAK GROUP, INC.
(Registrant)

Date: November 7, 1983

By:
Daniel Lezak,
President
(Chief Executive,
Financial and Accounting
Officer)

Senator D'AMATO. What do you know about this M. H. Myerson & Co., Inc.? Have they been long established? What are they? Broker-dealers? Underwriters?

Mr. PINTO. Well, I know the firm has been in business—I started with NASD in 1969.

Senator D'AMATO. Speak right into one of those microphones so I can——

Mr. PINTO. I've been with the NASD since 1969. I started in the New York office. And I know they were members of the NASD back in 1969. So they have been around for awhile. They are a marketmaking firm.

Senator D'AMATO. A marketmaking firm. Do you know who they have made markets for? Are they underwriters?

Mr. PINTO. I think they underwrote several of the issues that were referenced in the Venture magazine article, yes.

Senator D'AMATO. Is that all you know about them?

Mr. PINTO. Well, no. Any of the investigations or reviews or any matters that NASD is looking at from the investigative side is not public information about their activities other than any types of disciplinary actions that might have been taken that do require publicity.

Senator D'AMATO. Have any investigatory actions culminated in any legal actions being taken against them or any disciplinary actions recommended by NASDAQ?

Mr. PINTO. Well, I—I——

Senator D'AMATO. I don't have this written down. I don't want to set you up. I'd like to know.

Mr. WILSON. I don't think sitting here today we know the answer to that question.

To the extent there have been such actions they are public information and we could be made available.

Mr. PINTO. I do know that there is one action that is still open. I believe the Commission hasn't resolved it yet regarding the firm. And I believe that is a public proceeding. And I can certainly look into that and provide that information, the fact that it is.

Senator D'AMATO. Now I'm looking at those questions that they prepared for me.

What, if any, special factors are considered when a client in NASDAQ's suitability rule to brokers engaging in the hot issue market, must brokers consider—well, I won't go on with that.

FAIR DEALING WITH CUSTOMERS

Mr. PINTO. Well, the association has rules dealing with fair dealing with customers and certainly addresses the fact that the recommendation of low-priced, speculative issues, that members have to be extremely careful in making those kinds of recommendations; the financial status of the customer, their investment objectives; all of these types of factors have to be taken into consideration.

And certainly if an investor's entire savings or a vast amount of his savings is going to be invested in one of these low-priced, speculative issues, certainly that's the kind of situation where a firm is supposed to be extremely careful because that is not the type of investment for that type of individual.

Senator D'AMATO. How do you follow up on that?

Mr. PINTO. Well, from an investigative side, during the course of our routine examinations—we conduct in the area of 3,000 examinations during the course of 1 year, both routine and special.

And during the course of a routine examination we will review customer account records. We will look into the background information of those customers and look at the kind of activity that has taken place in the account; looking for excessive activity, possible unauthorized transactions, transactions that don't appear suitable based on the customer's financial background, his investment objectives.

And that is incorporated, as I say, in all of the examinations that we conduct.

Senator D'AMATO. What is your procedure with dealing with customer complaints.

Mr. PINTO. Well, we have a rather sophisticated process for customer complaints.

First of all, we have a centralized, automated system out of Washington wherein all of the customer complaints that are received in all of our district offices throughout the country, as well as all of the customer complaints received by the SEC in the main office and the regional offices throughout the country that are sales practices related, all of that information is incorporated into one data bank.

The purpose of that is to try to determine whether there are any trends or patterns, any indications of concentration of customer complaints in a particular firm or perhaps in a particular branch office. But we have that as a control.

All of our customer complaints are reviewed in our district offices. Every one that we receive is reviewed by the districts.

This year we received close to 2,400 customer complaints. We have resolved close to 1,900 complaints. We conduct a review and that review varies in depth depending upon the kinds of circumstances.

We will correspond with the firms. We will interview people that are involved.

Senator D'AMATO. Have you had an increase in the number of complaints addressed to the hot issues or penny stocks recently?

Mr. PINTO. We've had an increase in—an overall increase in the number of customer complaints. But I don't believe there has been a concentration—a concentrated increase in——

Senator D'AMATO. That could be attributed to the general market; for example, the recent large increase in volume.

You heard Chairman Shad and Mr. Fedders testify to the fact that the bubble hasn't burst. I think I'm paraphrasing Mr. Fedders.

Do you think the bubble is going to burst? I'm talking specifically about hot issues.

Mr. MACKLIN. It's an interesting thing because, in addition to all of the regulatory mechanisms in place, the cold wind of economics is certainly a chilling corrective factor and has been in other hot issue markets.

This year it looks to us like there has been sort of an orderly winding down of the so-called hot issues. As Chairman Shad mentioned the number of total offerings is up sharply, and measured by the past, you've got 10 years worth of volume crammed into this year.

This year by the month—here are the number of questionnaires that we sent out. We sent out 12—well, 4 in January, 12 in February, 11 in March—these are issues as to which questionnaires went out—8 in April, 24 in May, 30 in June, 50 in July, 1 in August, 3 in September and 5 in October and projected 3 in November.

So there has been quite some tapering and peaking out in the market as measured by that standard since the middle of the year.

Coincidentally, coming in on the plane last night I picked up a Barron's magazine at the airport and they list, selective new issues, there were 43 issues, recent issues, of which there are only about 8 of them selling at premiums in excess of 10 percent.

So there is a lot of evidence around that says that the problem is substantially subsiding.

Senator D'AMATO. Again I think the point was well made. You're not going to find much in the way of misrepresentation or fraud in it, but rather you're going to scrub the kitchen sink and that's what they're going to do: go to great lengths to protect themselves by total disclosure, to the extent that they are going to say that they don't even have any business plan.

I find that absolutely incredible. I think it's unacceptable.

Mr. MACKLIN. Well, you know people in frothy markets do things that you just wouldn't believe either before or after the facts. And to buy things like that—our——

Senator D'AMATO. How do you track these stocks to see to it that the area where the greatest abuse may take place doesn't take place with respect to the market being made—the encouragement or discouragement to sell or trade in something else? That I think is important.

Mr. PINTO. There are a couple of factors.

First, once one of these issues does come on NASDAQ, it becomes subject to all of the automated surveillance programs that Gordon mentioned earlier.

SAFEGUARDS ON PRICE PARAMETER

We have a system whereby on a minute-to-minute basis, if the security exceeds any sort of a predetermined price parameter, it kicks out immediately as it breaks that parameter. An analyst follows up on that price break immediately; contacts the marketmaker, contacts the issuer, or if necessary makes referrals to the Commission or out to our district offices.

We are in the process of expanding the scope of that to also incorporate volume rates that have been exceeded.

In addition to that——

Senator D'AMATO. These are all of the stocks that NASDAQ——

Mr. PINTO. All of the securities, once they are on the NASDAQ system, they all become subject to this automated surveillance mechanism which incorporates a real time online system as well as 30 some odd reports that are generated overnight which utilize various volume and price pieces of information.

All of that is performed by professionals. We have 18 professionals in our market surveillance unit that do nothing but monitor the activity in that marketplace.

Senator D'AMATO. Well, suppose we find out that a price is falling and then starts to go up, and you get a couple of complaints saying the broker discouraged me from selling. What do you do? Supposing you have clear proof or have proof that substantiates that fact? What protections can be offered? What can you do; what can NASDAQ do?

Mr. **Pinto**. Well,——

Senator D'**Amato**. A little old lady says, "I wanted to sell, he wouldn't let me sell."

Mr. **Wilson**. If we find——

Senator D'**Amato**. In the hypothetical, we are determining that we find that to be the case.

Mr. **Wilson**. You have assumed the situation——

Senator D'**Amato**. Yes.

Mr. **Wilson** [continuing]. Where a violation has taken place and we have evidence to support the establishment of that violation.

We do have the authority under the 1934 act, the Maloney act amendment to it, to institute actions against the individuals concerned, that is, as long as they are members or registered representatives or principals of members of the NASD.

That process is initiated at a district committee level.

Our organization is divided geographically into 13 districts around the country. Each of those districts has a district committee.

They have the authority based upon the evidence and factual data submitted to them by the examining staff to initiate a formal complaint.

The respondents in those complaints have the right to be represented by counsel. They have a right to a hearing. And if a violation is found, a penalty is imposed.

The act gives us the authority to impose penalties of censure, a monetary fine, suspension from the association or expulsion from the industry.

The normal rights of appeal are available to all respondents.

Senator D'**Amato**. What is the dollar volume of fines that you levied, for example, in 1983?

Mr. **Wilson**. I think in 1983 it was a little over $1 million; I think $1.1 million.

Senator D'**Amato**. How many firms or different areas would that have covered? How many individuals? How many cases would that $1.1 million——

Mr. **Wilson**. If we don't have it with us, we can supply it for the record.

Senator D'**Amato**. You heard Mr. Fedders and Chairman Shad speak regarding the red flags, what people should be alert for.

What could NASDAQ do with its great capability and ability to service many people, and it being, I think, really a remarkable service that you provide policing the industry; what can you do to promote dissemination of that kind of information.

Don't you think that an investor should receive a prospectus regarding a new issue before he or she invests?

Mr. **Wilson**. Yes.

Senator D'**Amato**. Is there anything you can suggest that you could do to help promote the dissemination of that information to the investing public? I'm not talking about the sophisticated investor.

Mr. **Macklin**. Well, we require of our members to distribute a prospectus.

In terms of overall warnings to the public, why we have in years gone by when the climate has been particularly turbulent put fairly well-publicized releases to our members and others warning of the activities of the market.

As you measure this particular boon at this time it doesn't quite fit the profile or just the late stages of a New Year's Eve party like some of the previous bull markets have.

We do have that capability with a nationwide network of dealers to put in place should the occasion seem appropriate.

Senator D'AMATO. Counsel has written out a note here that says that the requirement is that a prospectus be delivered before a sale is executed on a new issue.

Is there a requirement?

Mr. MACKLIN. Yes.

Senator D'AMATO. There is. Do you think that requirement is being lived up to?

Mr. MACKLIN. I think before payment is made the prospectus is there.

The more difficult part is the one you spotted earlier. That's the desirability of reading what you get. I think there is.

Senator D'AMATO. So you're almost in a situation where you say you really deserve what you get. You know we don't mean it when people get hurt badly, but you are really saying that that is the case.

In your experience do most of the brokers even those who you've found or have driven out of the industry, do they live up to that requirement?

They probably do. They find if they give it, nobody reads it anyway.

What's your experience?

Mr. PINTO. I think the disclosures are made. They are there.

We've heard complaints from customers on the other side of it. They call and say, I wanted 1,000 shares, you only gave me 200 shares. I wanted to get in that deal; I couldn't get in that deal. Why don't you get ahold of that firm and find out why I was not able to partake of that offering.

CUSTOMERS RELUCTANT TO COME FORWARD

The customers, on the other side, are very, very reluctant to come forward on the negative side while the market is booming for fear they will be locked out of future deals.

And yet they come in and ask you for assistance to get into these deals.

Senator D'AMATO. Everybody wants to get rich quick. It's their own greed that is the focal point.

Because this man did it himself, Morgan Hardiman. This is terrible, Morgan. And nobody knows. He says that he bought one of these issues and never received a prospectus.

Well, he didn't even ask for it.

Mr. HARDIMAN. Yes, I did.

Senator D'AMATO. You asked for it. And what happened? You bought it and you sent money?

Mr. HARDIMAN. Yes.

Mr. WILSON. The rules require the delivery of the prospectus to you and perhaps the right of rescission.

Senator D'AMATO. What's the stock doing now?

Mr. HARDIMAN. It's down.

Senator D'AMATO. So then he complains, you see.

Mr. MACKLIN. There you go.

Senator D'AMATO. He is a great witness. That is Morgan Hardiman for the record.

He is honest anyway. I don't know how smart he is.

It's down. Did you try to sell it?

Mr. HARDIMAN. No. I'm going to hold on to it.

Senator D'AMATO. Well, let me say, we have some additional data on the fines. I just wanted to update on the fines.

Through the end of September, $1.1 million is the accurate figure on the fines. And that involves levying fines against 73 firms, 124 individual persons.

Senator D'AMATO. When do you fine them and when do you put them out of business?

Give me an example of a circumstance that calls for a fine as opposed to one that warrants an injunction from doing business.

Mr. WILSON. That, of course, depends on the seriousness of the case and the nature of the violation.

Just like anything else, there are many cases where mitigating factors are involved; in other cases there are aggravating factors.

And our committee and finally our board has to take those things into consideration.

Certain kinds of violations, such as manipulations are considered extremely serious in all situations.

But you can't say in every case expulsion or suspension takes place.

Senator D'AMATO. What about a manipulation?

Mr. WILSON. Manipulation is considered a very serious violation.

Senator D'AMATO. And if it's proven beyond a doubt——

Mr. WILSON. It's very possible that you can be expelled.

Senator D'AMATO. How many expulsions have you had in 1983?

Mr. PINTO. Thus far this year we have expelled 6 firms and we barred 30 individuals.

Suspended 3 firms and suspended 24 individuals.

Senator D'AMATO. Is that rate up?

Mr. PINTO. That rate is fairly comparable to last year.

Last year, for the entire year, we barred 34 individuals and suspended 43 individuals and expelled 5 firms.

Senator D'AMATO. Given the great increase again in volume and offerings, it's not——

Mr. PINTO. No. As a matter of fact, if the trend continues to the end of the year the number of bars and suspensions for individuals might be a little less than it was last year.

Mr. WILSON. I think, however, that you have to recognize that many times the disciplinary process trails the market by some period of time, 1 to 1½ years.

Senator D'AMATO. Then it's not unreasonable to expect increased enforcement activity?

Mr. WILSON. Yes. It could. I don't want to predict it. But it's extremely possible.

Senator D'AMATO. Gentlemen, let me thank you very much for your participation.

We are going to keep the record open—and any comments that you might want to make with respect to the legislative initiatives, you may go back and talk to the board with respect to that.

We would welcome that. I know Chairman Shad has a fine working relationship with you, and I'm certain that you will keep that relationship strong and offer him some suggestions in that regard as well.

I thank you very much for your participation.

Mr. MACKLIN. Thank you very much.

Mr. WILSON. We will add to the record our NASDAQ pack which talks about the different qualifications for various levels of eligibility.

[The NASDAQ fact book follows:]

NASDAQ Market Highlights in 1982

Investors in NASDAQ OTC securities	10 million
Companies issuing NASDAQ securities	3,264
NASDAQ securities quoted in the NASDAQ System	3,664
Market makers in NASDAQ securities	407
Number of market making positions in NASDAQ securities	27,734
Average number of market makers per NASDAQ security	7.6
NASDAQ share volume in 1982 (7.8% higher than in 1981, the previous volume record year)	8.43 billion
NASDAQ Composite Index gain in 1982	18.7%
NASDAQ National Market System 1982 share volume (40 securities on April 1, 84 at year-end)	1.09 billion
NMS share volume as a percentage of total 1982 NASDAQ volume	13.0%

To NASDAQ Companies, NASD Members and Friends

The NASDAQ market in 1982 was marked by four outstanding developments:

- Record share volume and index performances for the 12-year history of the market;
- The start-up of the NASDAQ National Market System, the prototype of the stock market of the future;
- The further evolution of NASDAQ from a nationwide market into a worldwide one; and,
- The highest degree of NASDAQ company participation in NASD and NASDAQ activities since the market was established in 1971.

NASDAQ Share Volume and Index Performances

In 1982, NASDAQ volume set a new record for the fifth consecutive year with 8.43 billion shares traded. This was 7.8% more than in 1981, over three times the volume in 1978 and nearly four times the volume in 1972, the first full year for which NASDAQ share volume was computed.

The price performances of NASDAQ securities in 1982 were also record-breaking. The NASDAQ Composite Index reached an all-time high of 240.70 in early December and closed 1982 at 232.41, a gain of 18.7% for the year. Five of the six NASDAQ sub-indices established record highs and closed the year with gains ranging from 9% to 57%. The NASDAQ Industrial Index did not break its May 1981 record until January 1983.

Comparisons with the Exchanges

In 1982, the NASDAQ market further consolidated its position as the second-largest and fastest-growing stock market in the U.S. NASDAQ share volume in 1982 was over half of NYSE volume and more than six times AMEX volume. The numbers of NASDAQ issuers and issues were greater than those of the NYSE and the AMEX combined. Over the five-year period 1978-82, NASDAQ volume more than tripled, while NYSE volume grew 2.3 times and AMEX volume 1.4 times.

The NASDAQ Composite Index, with its 1982 gain of 18.7%, outperformed the NYSE Composite Index, which gained 14.0%, the Standard & Poor's 500, up 14.8%, and the AMEX Market Value Index, up 6.2%. The Dow Jones Industrials edged out the NASDAQ Composite Index with a gain of 19.9% for the year.

In terms of shareholder population, statistics compiled by the NYSE show that NASDAQ and other OTC shareholders increased by 97%, to 10,000,000 during 1975-81, while NYSE shareholders increased by 50% and AMEX shareholders by 67%.

NASDAQ Issuers, Securities and Market Makers

The NASDAQ market's share volume, liquidity, price performance and competitive multiple market maker system continued to make it attractive to issuers. Some 600 NASDAQ securities are eligible for listing on the NYSE and 1,600 are eligible for the AMEX, but they remain in the NASDAQ market largely because their issuers prefer the competitive multiple market maker system of NASDAQ to the single specialist system of the exchanges.

The most active NASDAQ issue was MCI Communications Corporation with 206.9 million shares traded. This volume established MCI as the third most active issue in all U.S. markets, slightly behind the two NYSE volume leaders, IBM and EXXON, and far ahead of AT&T, the third-ranking NYSE security by volume.

The top NASDAQ security in terms of market value of total shares outstanding was American International Group, Inc., which exceeded $4.5 billion.

At the end of 1982, the profile of the average security on the NASDAQ National List, which comprised 1,912 securities and was published in 81 newspapers, showed the following:

Price per share	$15
Total shares outstanding	7,325,377
Total market value	$109.9 million
Total company assets	$377.7 million
Shareholders equity	$55.0 million
Total revenues	$125.2 million
Net income	$6.7 million

There were 407 NASDAQ market makers at the end of 1982. They had 27,734 positions in NASDAQ securities for an average of 7.6 market makers per security.

The NASDAQ National Market System

Within the overall NASDAQ market, the most significant development was the April 1, 1982, start-up of the NASDAQ National Market System (NMS).

NASD Chairman Ernest F. Rice, Jr. (center) with President Gordon S. Macklin (left) and J.M. (Mac) Hill (right).

The significance of NMS is that, for the first time ever, the competitive multiple market maker system is combined with up-to-the-minute reporting of trades. Thus, the unique strength of the NASDAQ market is enhanced by continuously available last-sale data, identical to that available on exchange-listed securities.

At the April start-up, 40 NASDAQ securities were mandated by SEC rule into the NMS trading environment. These were securities which met the SEC's criteria of an average volume of 600,000 shares a month during a six-month period and a minimum bid price of $10 for five days prior [illegible] the qualification date. As a result of quarterly reviews of NASDAQ activity, it was determined that additional securities qualified for NMS throughout the year and, at the end of 1982, 84 securities were traded in the System.

During the April to December period, the aggregate volume of the 40-84 NASDAQ NMS securities totaled 1.09 billion shares. This was more than the aggregate volume of all AMEX stocks during the same time, and represented 13% of total NASDAQ volume for the year.

Market maker support for the NMS securities continued strong, at over 17 market makers per security. Individual and institutional investor interest was spurred by the increased visibility of the securities, through real-time trade reporting. A substantial amount of the NMS trading was done in blocks of over 10,000 shares.

NASD Market Surveillance developed new automated facilities and procedures to determine the compliance of NASDAQ market makers with the real-time trade reporting requirements of NMS. Among other findings, Market Surveillance noted that 99.8% of NMS trades sampled were reported at the prevailing market or within an acceptable deviation from the last-sale price. Additional surveillance capabilities were prepared for 1983 utilization.

In February 1983, 100 more NASDAQ securities entered the NMS. Half of these were securities which, at the end of 1982, met the SEC criteria for mandatory inclusion in NMS. The other half were securities entering on voluntary application of their issuers. These issues met less stringent SEC criteria of at least 100,000 shares a month volume over a six-month period and a bid price of $5 for five business days prior to the qualification date.

The NASD is currently conducting a study of the impact of real-time trade reporting on the NMS securities, market makers and on the capabilities of the NASDAQ System. Unless significant adverse findings are uncovered by the study, 100 securities meeting the voluntary designation criteria will be included in NMS in May, and 100 each month thereafter, until all applications for voluntary inclusion have been accommodated.

The NASDAQ Market, Nationwide and Worldwide

The 184 NASDAQ NMS and 3,480 NASDAQ securities together made up a total of 3,664 securities in the NASDAQ market at the end of 1982. During the year, 2,005 advanced, 1,499 declined and 160 were unchanged. There were 752 with price gains of 50% or more, and 546 with losses of 50% or more.

The NASDAQ market is not only a nationwide market, but it has also evolved into a market that is worldwide. NASDAQ companies are headquartered in all 50 states and the District of Columbia and Puerto Rico. Worldwide, there are 256 NASDAQ issuers headquartered in 18 foreign countries, and there are a great number of overseas branches of U.S. securities firms, foreign securities firms and foreign financial institutions actively involved in the trading of NASDAQ securities.

The NASDAQ System, the automated communications facility for this nationwide and worldwide market, was overhauled and brought to state-of-the-art levels in 1981-82 through an investment of $22 million. Another $5 million is being spent in 1983 to increase the capacity and performance of the System. This will fully equip the System to meet the demands of record-breaking volume days on NASDAQ and of the new automated services which are being provided to the market.

NASDAQ Company Participation in NASD and NASDAQ Activities

The fourth major development in the NASDAQ market in 1982 — in addition to the record overall NASDAQ performance, the inception of the NASDAQ National Market System and the further evolution into a worldwide market — was the very substantial participation by NASDAQ companies in NASD and NASDAQ activities.

NASDAQ companies extensively availed themselves of the advisory services of four NASDAQ Corporate Consultants; W. Eugene Cartwright in the Far West, Douglas H. Curtis in the Midwest, Raymond J. Kiernan in the Southeast and Lewis M. Weston in the Northeast. A fifth Consultant, Byron W. Cain, Sr., joined the team at the end of 1982 to render assistance to NASDAQ companies in the Central and Rocky Mountain states.

In 1975, the first NASDAQ executive was elected to the Board of Governors of the NASD; in 1983, five top executives of NASDAQ companies are now serving on the Board. The NASD Corporate Advisory Committee was established in 1979 with 11 members; it was raised to the status of Corporate Advisory Board in 1982; and, in 1983, it has been expanded to 15 members.

The charter of the Corporate Advisory Board is as broad as that of NASDAQ and the NASD itself. The Board is authorized and encouraged to examine and make recommendations for any and all NASDAQ and NASD activities. The Board played an important role in the introduction of inside quotations in 1980 and is playing a major part in NMS development now.

NASDAQ executives are also involved in other key NASD Committees: the Trading Committee, which develops policy recommendations for the NASDAQ System, the regulation of market makers and the qualifications standards for NASDAQ securities; the National Market System Securities Qualifications Committee, which selected the NASDAQ securities that voluntarily entered NMS in February 1983; the National Business Conduct Committee, which reviews all disciplinary decisions made by NASD District Committees against broker/dealers and their employees; and, the Information Committee which, among other things, administers the National List and local newspaper quotations of NASDAQ securities.

The participation of NASDAQ executives is a vital element in the overall guidance and support which the NASD also receives from hundreds of dedicated volunteers from securities firms, from financial institutions and from professions related to the securities industry. These combined efforts have contributed greatly to the results summarized in this 1982 Fact Book.

Ernest F. Rice, Jr.
1982 Chairman
National Association
of Securities Dealers, Inc.

Gordon S. Macklin
President
National Association
of Securities Dealers, Inc.

J.M. (Mac) Hill
Chairman
NASD Corporate
Advisory Board

1982: Fifth Consecutive Year of Record Volume
Six Indices at All-Time Highs

Volume Records

For the fifth consecutive year, the NASDAQ market set a new volume record and further consolidated its position as the fastest-growing and second-largest stock market in the U.S. Volume hit an all-time high for a single day on November 4 when nearly 70.5 million shares were traded, and nine of the top 10 volume days in the 12-year history of NASDAQ occurred in 1982. Monthly volume exceeded 1 billion shares for the first time in November and for a second time in December. Annual share volume went over the 8-billion mark for the first time and totaled 8.43 billion. This compares with prior years as follows:

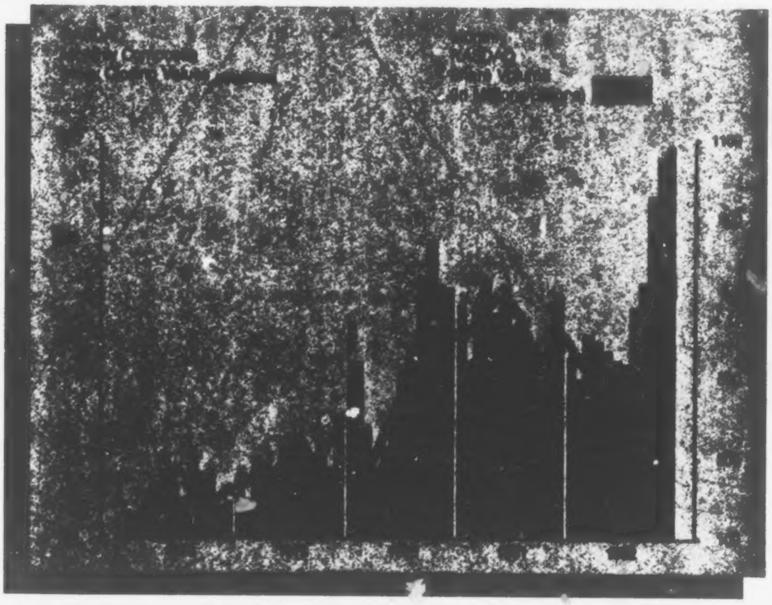
Year	Volume (billions)	Gain
1982	8.43	7.8%
1981	7.82	17%
1980	6.69	83%
1979	3.65	32%
1978	2.76	43%

(Until 1978, the record NASDAQ volume year was 1972, with 2.22 billion shares traded.)

Six Index Records

The NASDAQ Composite Index reached an all-time high for the 12 years of the NASDAQ System at 240.70 on December 8 and closed the year at 232.41, up 18.7% from the end of 1981. By comparison, the NYSE Composite Index was up 14.0%, the S&P 500 gained 14.8% and the AMEX Market Value Index rose 6.2%. The Dow Jones Industrials edged out the NASDAQ Composite Index with a gain of 19.9% for the year.

Five of the NASDAQ sub-indices — Bank, Other Finance, Insurance, Transportation and Utility — hit all-time highs in 1982 and closed 1982 with gains. The NASDAQ Industrial Index came close to its all-time high and also closed the year with a gain (see Pages 6-7). In January 1983, the Industrial Index broke its May 1981 record.



NASDAQ Index Performances 1982*

1982 Monthly Closing Values

Index	Number of Securities in Index 12/31/82	January	February	March	April	May
Composite	2,961	188.39	179.43	175.65	184.70	178.54
Industrial	2,254	218.92	204.12	199.05	212.64	205.41
Other Finance	419	170.37	167.04	165.00	168.51	164.76
Insurance	93	189.22	188.91	188.09	192.76	182.85
Bank	101	142.79	140.41	136.66	139.85	136.42
Utility	53	179.81	180.74	175.40	187.82	185.47
Transportation	41	164.28	155.38	148.10	163.21	152.26

*Only domestic common stocks traded solely in the NASDAQ market are included in the indices. Not included in the 1982 indices are 43 domestic common stocks also traded on regional exchanges.

NASDAQ Index Comparisons 1971-1982

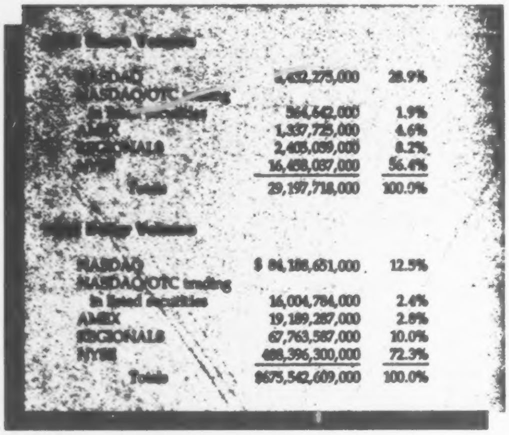
1971-82 Yearly Highs, Lows, Closes & Percent Changes for the Year

Index		1971	1972	1973	1974	1975
Composite	High	114.12 12/31	135.15 12/08	136.84 1/11	96.53 3/15	88.00 7/15
	Low	99.68 2/22	113.65 1/03	88.67 12/24	54.87 10/03	60.70 1/02
	Close	114.12	133.73	92.19	59.82	77.62
	% Change	+14.1	+17.2	−31.1	−35.1	+29.8
Industrial	High	116.53 12/31	144.14 5/26	136.97 1/11	89.78 3/15	93.79 7/15
	Low	98.13 11/23	115.97 1/03	80.15 12/24	54.21 10/03	57.22 1/02
	Close	116.53	132.41	83.57	56.46	80.95
	% Change	+16.5	+13.6	−36.9	−32.4	+43.4
Other Finance	High	116.91 12/31	151.61 11/14	151.93 1/11	111.60 1/23	88.47 6/24
	Low	100.00 2/05	116.31 1/03	102.93 12/24	57.16 10/03	64.70 1/02
	Close	116.91	148.95	107.50	63.43	79.02
	% Change	+16.9	+27.4	−27.8	−41.0	+24.6
Insurance	High	122.29 10/12	152.81 12/01	149.69 1/03	113.46 1/17	91.19 7/15
	Low	97.56 2/22	119.73 1/26	103.22 5/21	57.57 10/03	73.47 9/17
	Close	121.33	149.03	110.15	74.69	80.90
	% Change	+21.3	+22.8	−26.1	−32.2	+ 8.3
Bank	High	105.03 4/29	120.75 10/10	123.57 1/22	105.11 1/17	82.76 7/15
	Low	94.88 11/24	100.60 1/26	96.50 12/05	59.43 10/04	62.22 1/02
	Close	101.82	119.11	100.42	61.49	72.37
	% Change	+ 1.8	+17.0	−15.7	−38.8	+17.7
Utility	High	100.94 4/15	99.02 11/28	101.30 2/20	76.55 3/06	69.52 6/30
	Low	90.18 12/02	91.84 6/26	69.85 12/05	48.22 12/24	50.44 1/02
	Close	94.37	98.60	72.07	49.60	65.95
	% Change	− 5.6	+ 4.5	−26.9	−31.2	+33.0
Transportation	High	120.12 12/31	133.21 3/06	124.95 1/12	96.66 3/15	90.92 7/14
	Low	99.57 2/23	115.56 10/19	77.65 12/21	61.24 12/23	66.67 1/06
	Close	120.12	117.50	81.04	65.79	85.52
	% Change	+20.1	− 2.2	−31.0	−18.8	+30.0

June	July	August	September	October	November	December
171.30	167.35	177.71	187.65	212.63	232.31	232.41
196.33	191.32	204.33	213.35	244.12	269.62	273.58
158.52	155.52	165.99	177.31	198.07	212.79	207.50
172.49	168.54	184.73	201.84	217.72	231.56	226.40
130.61	128.61	130.27	134.16	148.25	158.39	156.37
196.24	188.25	190.89	213.82	257.83	292.58	286.23
151.46	153.36	160.08	172.50	193.83	195.35	195.48

1976	1977	1978	1979	1980	1981	1982
97.88 12/31 78.06 1/02 97.88 +26.1	105.05 12/30 93.66 4/05 105.05 + 7.3	139.25 9/13 99.09 1/11 117.98 +12.3	152.29 10/05 117.84 1/02 151.44 +28.1	208.15 11/28 124.09 3/27 202.34 +33.9	223.47 5/29 175.03 9/28 195.84 − 3.2	240.70 12/08 159.14 8/13 232.41 +18.7
100.12 12/31 81.44 1/02 100.12 +23.7	109.43 12/30 96.29 4/26 109.43 + 9.3	155.79 9/12 101.91 1/11 126.85 +15.9	175.18 12/31 126.88 1/02 175.18 +38.1	274.70 11/28 145.03 3/27 261.36 +49.2	283.03 5/29 204.62 9/25 229.29 −12.3	281.64 12/08 177.70 8/13 273.58 +19.3
101.57 12/31 79.36 1/02 101.57 +28.5	105.65 7/25 97.04 4/06 105.53 + 3.9	129.85 9/13 101.11 1/16 114.43 + 8.4	139.50 8/24 114.18 1/02 130.92 +14.4	154.07 12/31 106.35 3/27 154.07 +17.7	182.10 6/25 154.61 1/02 176.20 +14.4	216.40 12/08 152.45 8/13 207.50 +17.8
105.21 12/31 81.60 1/02 105.21 +30.0	115.01 11/25 96.14 4/04 114.51 + 8.8	144.14 9/11 106.71 1/16 127.[illegible]4 +1[illegible].1	166.31 10/05 126.58 1/02 162.03 +27.3	184.71 9/23 128.74 3/27 166.81 + 3.0	204.77 6/15 166.10 2/13 194.31 +16.5	236.76 12/06 163.78 8/13 226.40 +16.5
92.72 12/31 72.73 1/02 92.72 +28.1	96.02 12/05 89.64 5/31,6/06 95.28 + 2.8	111.56 10/13 93.96 1/11 102.33 + 7.4	115.81 8/31 102.09 1/03 108.24 + 5.8	118.58 12/24 91.99 3/27 118.39 + 9.4	144.06 12/01 118.59 1/02 143.13 +20.9	160.73 11/12 127.84 8/13 156.37 + 9.3
86.91 12/31 66.15 1/02 86.91 +31.8	101.68 12/23 87.04 1/03 101.03 +16.2	116.73 9/13 93.23 1/20 106.04 + 5.0	130.41 12/31 106.27 1/02 130.41 +23.0	165.92 11/28 106.01 3/27 165.70 +27.1	191.18 11/30 148.69 2/04 181.67 + 9.6	316.17 12/08 168.02 3/12 286.23 +57.6
105.78 4/20 85.97 1/02 101.28 +18.4	104.40 7/22 91.60 4/25 97.68 − 3.6	128.71 9/13 92.92 1/23 100.53 + 2.9	133.42 10/04 100.76 1/02 118.47 +17.8	179.20 10/10 100.55 3/27 164.19 +39.0	201.71 6/15 155.99 1/08 167.77 + 2.2	205.81 11/05 145.26 3/16 195.48 +16.5

Trading in NASDAQ and Listed Securities



1982 Share Volume

NASDAQ	8,432,275,000	28.9%
NASDAQ/OTC trading in listed securities	564,642,000	1.9%
AMEX	1,337,725,000	4.6%
REGIONALS	2,405,059,000	8.2%
NYSE	16,458,037,000	56.4%
Totals	29,197,718,000	100.0%

1982 Dollar Volume

NASDAQ	$ 84,188,651,000	12.5%
NASDAQ/OTC trading in listed securities	16,004,784,000	2.4%
AMEX	19,189,287,000	2.8%
REGIONALS	67,763,587,000	10.0%
NYSE	488,396,300,000	72.3%
Totals	$675,542,609,000	100.0%

The share volume of trading in NASDAQ securities in 1982 was just over half the share volume of trading on the New York Stock Exchange and over six times the volume on the American Stock Exchange.

In off-board trading in NYSE- and AMEX-listed securities, a volume of some 565 million shares was done in the OTC market and reported through the NASDAQ System. This was nearly 20% of the total trading which was done in such securities on the regional exchanges and in the OTC market.

Five-Year Comparisons of NASDAQ, NYSE and AMEX
1978-1982

	NASDAQ			NYSE			AMEX		
	Issuers	Issues	Share Volume (billions)	Issuers	Issues	Share Volume (billions)	Issuers	Issues	Share Volume (billions)
1978	2,475	2,582	2.762	1,585	2,194	7.205	1,004	1,064	.989
1979	2,543	2,670	3.651	1,565	2,192	8.156	931	1,006	1.100
1980	2,894	3,050	6.692	1,570	2,228	11.352	892	973	1.626
1981	3,353	3,687	7.823	1,565	2,220	11.854	867	919	1.343
1982	3,264	3,664	8.432	1,526	2,225	16.458	834	944	1.338

Growth in Shareholder Population by Market
1975-1981

	NASDAQ Other OTC	NYSE	AMEX
1975	5,058,000	17,954,000	1,935,000
1980	8,486,000	23,804,000	2,808,000
1981	9,966,000	26,084,000	3,228,000
% Change 1975-81	+97%	+50%	+67%

Source: NYSE

Daily & Monthly NASDAQ Volume in 1982

The highest NASDAQ volume day ever was November 4, 1982 when 70,465,900 shares were traded. November 9 and 10 and December 1 and 8 also exceeded the previous record of 60,378,200 shares set on November 19, 1980.

Average daily NASDAQ share volume for the 253 trading days of 1982 was 33,329,149.

The all-time highest monthly volume for NASDAQ was 1,073,560,785 shares traded in December, exceeding slightly the November volume total of 1,069,701,300 shares. The previous record month had been October 1980, when 844,883,000 shares were traded. Monthly volume in 1982 averaged 702,689,573 shares, compared to 651,950,808 shares in 1981.

High, Low & Average Daily Volume

	High Day		Low Day		Daily	
Month	**Shares (000 omitted)**	**Date**	**Shares (000 omitted)**	**Date**	**Average (000 omitted)**	**Trade Days**
JANUARY	33,711	1/22	23,285	1/14	27,771	20
FEBRUARY	31,045	2/19	23,038	2/26	26,354	19
MARCH	33,442	3/9	21,196	3/26	26,561	23
APRIL	35,536	4/23	23,901	4/6	28,178	21
MAY	33,705	5/19	21,128	5/24	28,358	20
JUNE	30,960	6/23	20,503	6/1	24,881	22
JULY	30,627	7/8	19,366	7/2	25,769	21
AUGUST	50,845	8/26	23,594	8/10	30,854	22
SEPTEMBER	44,512	9/3	22,763	9/27	35,094	21
OCTOBER	57,016	10/21	26,461	10/4	45,491	21
NOVEMBER	70,466	11/4	26,966	11/26	49,843	21
DECEMBER	61,910	12/8	36,888	12/27	48,618	22
YEAR	70,466	11/4	19,366	7/2	33,329	253

Monthly Share & Dollar Volume

Month	**Reported Share Volume[1] (000 omitted)**	**Dollar Value of Reported Share Volume[2] (000 omitted)**	**Price of an Average Share Traded[3]**
JANUARY	555,751	$ 4,700,524	$ 8.45
FEBRUARY	501,343	3,938,117	7.85
MARCH	611,071	4,915,960	8.04
APRIL	592,772	5,205,741	8.78
MAY	567,782	4,856,616	8.55
JUNE	547,616	4,684,177	8.55
JULY	541,904	5,231,506	9.65
AUGUST	679,101	6,650,135	9.79
SEPTEMBER	737,945	7,769,770	10.52
OCTOBER	955,879	11,220,595	11.73
NOVEMBER	1,055,162	12,774,037	12.10
DECEMBER	1,073,561	12,241,475	11.40
TOTALS	8,432,275	$84,188,651	$ 9.98

[1] Reported share volume in a NASDAQ issue by a market maker is calculated by adding the net change in the market maker's inventory to the number of shares which the market maker both bought and sold during the day. For example, a market maker opens the day with an inventory of 5,000 shares of XYZ, Inc. During the day, he buys 2,000 additional shares and sells 4,000 shares, leaving a closing inventory of 3,000 shares. The difference between his opening and closing inventory is 2,000 shares. These 2,000 shares are considered as having changed ownership. An additional 2,000 shares flowed through the market maker's inventory, that is, they can be counted as having been both a buy and a sell. The 2,000 share net change in inventory is added to the 2,000 shares that flowed through the inventory, resulting in a total volume of 4,000 shares in XYZ, Inc. for the market maker. However, for NASDAQ issues traded in NMS, the reported share volume is calculated in the same manner as it is calculated for exchange-listed securities.

[2] NASDAQ daily dollar volume is the sum of each issue's daily share volume multiplied by the closing inside bid price, except that for NASDAQ NMS securities the daily share volume is multiplied by the last-sale price. Monthly dollar volume is the total of daily dollar volume figures for all trading days in the month.

[3] The price of an average share traded is computed by dividing dollar volume by share volume.

9

The 50 Most Active NASDAQ Securities by Share Volume in 1982

In terms of share volume, the 50 most active NASDAQ securities in 1982 ranged from a high of nearly 207 million to more than 13 million.

The Volume Leader

MCI stock (1) more than tripled its own share volume performance of 1981, (2) led all NASDAQ issues in trading volume, and (3) was the third most actively traded security in any U.S. market. The 206.9 million shares of MCI traded in the NASDAQ market in 1982 greatly exceeded the volume transacted on the NYSE in its three volume leaders — IBM, EXXON and AT&T. However, after regional exchange and OTC volume in both IBM and EXXON is added to the NYSE totals, MCI stands as the third most actively traded stock in the nation in 1982, well ahead of AT&T.

Security	1982 Share Volume
* 1. MCI Communications Corporation	206,909,600
* 2. Apple Computer, Inc.	96,258,300
* 3. Tandem Computers Incorporated	79,026,500
* 4. Intel Corporation	67,097,200
5. Energy Reserves Group, Inc.	51,931,100
6. Air Florida Systems, Inc.	35,437,100
* 7. Graphic Scanning Corp.	33,011,200
* 8. Pabst Brewing Company	31,496,300
* 9. Convergent Technologies, Inc.	31,102,100
*10. Sykes Datatronics Inc.	29,214,500
11. DeBeers Consolidated Mines Limited ADR	28,864,100
*12. Tandon Corporation	27,543,800
13. MGF Oil Corporation	27,301,600
*14. First Executive Corporation	26,947,200
*15. Tom Brown, Inc.	25,897,000
*16. CPT Corporation	25,616,800
17. Fared Robot Systems, Inc.	24,099,600
*18. Seagate Technology	23,544,900
*19. Peoples Restaurants, Inc.	22,809,900
*20. ISC Systems Corporation	22,200,700
21. Minerals and Resources Corporation Limited ADR	21,949,700
*22. Service Merchandise Company, Inc.	21,836,600
23. Nimslo International, Limited ADR	21,049,400
*24. Intermedics, Inc.	20,796,100
*25. American International Group, Inc.	20,098,600
26. Fuji Photo Film Co., Ltd. ADR	18,823,000
*27. Cross & Trecker Corporation	18,766,300
*28. Avantek, Inc.	18,530,400
*29. Tampax Incorporated	17,828,500
*30. United States Surgical Corporation	17,692,000
*31. American Greetings Corporation, Class A	16,836,100
32. Equinox Solar, Inc.	16,833,200
*33. Farmers Group, Inc.	16,355,200
*34. El Paso Electric Company	16,303,100
*35. Quotron Systems, Inc.	15,435,200
*36. The St. Paul Companies, Inc.	15,267,800
*37. Pizza Time Theatre, Inc.	15,154,300
*38. Digital Switch Corporation	14,724,200
*39. Chi-Chi's, Inc.	14,632,500
*40. Comdial Corporation	14,213,500
*41. Nike, Inc., Class B	14,178,500
42. American Surgery Centers Corporation	14,166,300
43. American Quasar Petroleum Co.	14,115,500
*44. Amarex, Inc.	14,106,800
*45. Regency Electronics, Inc.	14,099,500
*46. Jerrico, Inc.	13,972,900
*47. Intergraph Corporation	13,957,800
*48. Economics Laboratory, Inc.	13,938,900
*49. Millipore Corporation	13,875,400
*50. Chart House Inc.	13,379,600

**Indicates NASDAQ National Market System security as of February 1983.*

NOTE: All of the above securities had a 1982 closing inside bid price of $1.00 or more.

$153.1 Billion in Market Value and the 50 Leaders

The aggregate market value of the 2,961 domestic common stocks quoted on NASDAQ and traded solely in the NASDAQ market was $153.1 billion at the end of 1982, up $28.3 billion over the reported 1981 total. Total shares outstanding of these stocks were 17,143,819,000.

The 50 top domestic common NASDAQ securities on December 31, 1982, in terms of market value (the closing inside bid price multiplied by the number of shares outstanding) are shown in the accompanying table.

Security	Total Shares Outstanding** (000 Omitted)	Market Value (000 Omitted)
* 1. American International Group, Inc.	57,663	$4,555,377
* 2. MCI Communications Corporation	97,742	3,562,640
* 3. Intel Corporation	44,973	1,731,460
* 4. Apple Computer, Inc.	57,529	1,718,678
* 5. The St. Paul Companies, Inc.	21,386	1,307,219
* 6. Farmers Group, Inc.	33,952	1,196,808
* 7. Roadway Services, Inc.	19,857	1,136,813
* 8. SAFECO Corporation	18,708	972,816
* 9. Tandem Computers Incorporated	37,433	949,862
10. Berkshire Hathaway Inc.	987	764,925
*11. Pioneer Hi-Bred International	31,922	750,167
12. PACCAR Inc.	9,068	745,843
*13. Allied Bancshares, Inc.	23,707	699,356
*14. Tandon Corporation	22,142	697,473
*15. Sensormatic Electronics Corporation	15,938	689,318
16. Food Town Stores, Inc.	26,096	685,020
*17. Convergent Technologies, Inc.	19,867	665,544
*18. Shared Medical Systems Corporation	12,061	658,832
*19. Banc One Corporation	16,566	637,791
20. Pacific Telecom, Inc.	17,664	635,904
21. Servicemaster Industries, Inc.	14,544	610,848
*22. The Chubb Corporation	12,309	610,834
*23. Pic 'N' Save Corporation	15,631	601,793
*24. Willamette Industries, Inc.	15,243	575,423
*25. Tampax Incorporated	11,283	564,150
26. Commerce Clearing House, Inc.	9,000	558,000
*27. Intergraph Corporation	11,587	553,279
*28. Kemper Corporation	14,355	541,901
*29. Betz Laboratories, Inc.	15,849	534,904
*30. Quotron Systems, Inc.	15,812	533,655
*31. The Price Company	10,977	526,896
*32. First Bank System, Inc.	14,489	519,793
33. Multimedia, Inc.	10,187	499,163
34. Ohio Casualty Corporation	11,507	493,363
35. Wyman-Gordon Company	19,146	488,223
36. The A.C. Nielsen Company, Cl A	6,972	482,811
37. Provident Life and Accident Insurance Company	9,508	480,154
*38. American Greetings Corporation, Cl A	12,584	475,046
*39. Tele-Communications, Inc., Cl A	16,250	450,937
*40. American National Insurance Company	28,974	441,853
41. Tecumseh Products Company	5,470	432,130
42. Molex Incorporated	6,515	423,475
*43. InteCom Inc.	12,992	418,992
*44. Shoney's, Inc.	14,546	418,197
*45. Nordstrom, Inc.	8,367	405,799
*46. Service Merchandise Company, Inc.	14,475	405,300
*47. Adolph Coors Company, Cl B	33,751	405,012
48. Subaru of America, Inc.	6,054	399,564
*49. The Rouse Company	14,982	398,895
50. Pittsburgh National Corporation	12,393	396,576

*Indicates NASDAQ National Market System security as of February 1983.

**As reported to NASDAQ C[illegible]ions by December 31, 1982.

NASDAQ National List and NMS Companies and Their Securities — Profiles and Standards

Profiles

At the end of 1982, there were 1,912 NASDAQ securities in the National List, the principal NASDAQ stock table published in 81 U.S. and overseas newspapers.

As of February 1983, there were 184 securities traded in the NASDAQ NMS (See Pages 14-15).

The average characteristics of each of these categories of securities and of the companies which issued them were the following:

National List Profiles

Securities Data

• Price per share	$15
• Public float (shares)	5.4 million
• TSO	7.3 million
• Market value	$109.9 million

Company Data*

• Total assets	$377.7 million
• Shareholders equity	$55.0 million
• Total revenues	$125.2 million
• Net income	$6.7 million

NMS Profiles

Securities Data

• Price per share	$23.38
• P/E ratio	19.8**
• TSO	10.7 million
• Market value	$214.3 million
• Number of market makers	15.6

Company Data*

• Total assets	$658.2 million
• Shareholders equity	$137.6 million
• Total revenues	$302.1 million
• Net income	$19.4 million

**Based on companies' annual report information on file with the NASD as of December 31, 1982.*

***Average P/E ratio for stocks on the NYSE was 10.4, and for stocks on the AMEX 17.4.*

NASDAQ, National List and NASDAQ NMS Qualification Standards

Standard	For Initial NASDAQ Inclusion (domestic common stocks)*	For Continued NASDAQ Inclusion (domestic common stocks)*	For Newspaper National List Inclusion		SEC Criteria for Mandatory NMS Inclusion	SEC Criteria for Voluntary NMS Inclusion
			Alternative 1	Alternative 2		
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent	Yes	Yes	Yes	Yes	Yes	Yes
Total Assets	$2 million	$750,000	$2 million	$2 million	—	—
Tangible Assets	—	—	—	—	$2 million	$2 million
Capital and Surplus	$1 million	$375,000	$1 million	$8 million	$1 million	$1 million
Net Income	—	—	$300,000 in latest or 2 of 3 last fiscal years	—	—	—
Operating History	—	—	—	4 years	—	—
Public Float (shares)	100,000	100,000	350,000	800,000	500,000	250,000
Market Value of Float	—	—	$2 million	$8 million	$5 million	$3 million
Minimum Bid	—	—	$3	—	$10 on 5 business days	$5 on 5 business days
Trading Volume	—	—	—	—	Average 600,000 shares/month for 6 months	Average 100,000 shares/month for 6 months
Shareholders of Record	300	300	300	300	300	300
Number of Market Makers	2	1	2	2	4 on 5 business days	4 on 5 business days

**Qualification standards for other types of securities are available upon request from the NASDAQ Operations Department in Washington, D.C.*

The NASDAQ National Market System

The NASDAQ National Market System is a special sector of the entire NASDAQ market.

Origins of NASDAQ NMS

A national market system was mandated by Congress in 1975 to increase competition and efficiency in the securities markets and to provide investors with broader access to market information and better execution of orders. In implementing the will of Congress, the SEC subsequently ruled that not only listed securities but also a number of securities quoted on the NASDAQ System should be included in the national market system.

To do this, the Commission proposed that selected NASDAQ securities should be subject to the same kind of real-time transaction reporting as there is on exchange-listed securities. The Commission did not propose to replace the network of competing NASDAQ market makers with the single specialist system of the exchanges, but instead it proposed a combination of competing market makers and transaction reporting.

NMS Securities Qualifications

For the first group of NASDAQ securities to enter NMS, the SEC set a high volume criterion, an average of at least 600,000 shares a month traded over a six-month period prior to the qualification date. It also specified a minimum bid price of $10 a share for five business days before that date, and a number of other financial criteria (see Page 12).

Forty NASDAQ securities met the SEC criteria in January 1982 and were mandated, by SEC rule, into NMS on April 1, 1982. The SEC rule also requires the NASD to review all NASDAQ securities at the end of each quarter to determine whether any more had met the NMS criteria. This led to the addition of eight more securities in NMS in May, 12 more in August and 24 in November (due to the volume surge in the latter part of the year in all markets) for a total of 84 at the end of 1982. An additional 100 NASDAQ issues entered NMS in February 1983.

Similarities and Differences in Trading

The trading of the NASDAQ NMS securities is like that of other NASDAQ issues, in that it is carried out by competing multiple market makers. The average number of market makers per NASDAQ NMS security at the end of 1982 was 17.1; for all NASDAQ securities, it was 7.6.

The differences between the trading of NASDAQ NMS securities and other NASDAQ securities are:

- For NASDAQ-only securities, market makers throughout the trading day enter into the NASDAQ computer only their bid/ask quotations on each of the stocks in which they make a market. For NMS securities, in addition to entering quotations, market makers must report the actual price of each transaction within 90 seconds of its occurrence;
- For NASDAQ-only securities, market makers must aggregate the day's purchases and sales volume in each security in which they make a market, and report the aggregate for each security to the NASDAQ computer at the end of the trading day. For NASDAQ NMS securities, market makers must report the number of shares comprising each transaction throughout the day, at the time the price report is made; and,
- As a result, for NMS securities, NASDAQ terminals and securities salesmen's quotations terminals now show, throughout the day, high, low and last-sale prices and cumulative volume figures, as well as bid and ask quotations.

Visibility, Investor Interest and Volume

The additional information available on NASDAQ NMS securities and the currency of the information gives these issues special visibility to securities professionals and investors. As a result, the April-December 1982 volume in the 40-84 NMS securities was 1.09 billion shares, more than the aggregate volume of all AMEX securities during the same period.

The NASDAQ System: The $22 Million Upgrading Becomes $27 Million

During 1981 and 1982, the NASDAQ System's capabilities were significantly enhanced by a $22 million overhaul of the computerized core of the System. The crux of this effort was the replacement of the central computers in Trumbull, Connecticut by a UNIVAC 1100/82 System with three times the memory capacity and twice the speed of its predecessor.

With record-breaking share volume on NASDAQ and new NMS-related services on the drawing board, the NASD plans to spend an additional $5 million in 1983 to continue upgrading the NASDAQ System. A third UNIVAC computer will be installed, increasing the central processing capability by 50%. Regional concentrators in Chicago and San Francisco have been replaced by more powerful computers and additional concentrator capacity is scheduled to be added on the East Coast.

New NASDAQ Terminals, Heavy Traffic

A new generation of NASDAQ terminals was introduced in 1981-82 to handle increased NASDAQ traffic and the sophisticated requirements of NMS trading. During 1982, the number of NASDAQ Level 3 terminals in use by market makers grew from 1,420 to 1,462. Level 3 terminals display the quotations of all the market makers on all NASDAQ securities and also have an entry capability whereby market makers can keep their quotations current on the stocks in which they make markets.

The number of NASDAQ Level 2 terminals in use by financial institutions and others grew from 202 to 251, an increase of 24%. Level 2 terminals display the quotations of all the market makers in all NASDAQ securities but have no entry capability.

Average daily traffic in the NASDAQ System was 905,788 calls and the peak traffic for a single day was 1,257,471 calls.

16% More Securities Salesmen's Quotation Terminals

The number of securities salesmen's quotation terminals receiving NASDAQ information again rose substantially, from 69,817 to 81,218, a gain of 16%. These terminals are distributed by market data vendor organizations whose computers are connected to the NASDAQ System's central computers. They display the last-sale and volume data on NASDAQ NMS securities and the best current bid/asked price on any NASDAQ security. As shown on Page 41, over 6,500 of these 81,218 terminals are in use outside the U.S.

New NASDAQ NMS Services

For NASDAQ NMS, the NASDAQ System receives and displays last-sale information in addition to the bid/asked data. From the start-up of NMS on April 1 to the end of 1982, the System processed an average of 4,810 transaction reports a day in timely fashion and the transaction information became instantly available on the salesmen's quotation terminals and on the Level 2 and Level 3 terminals.

In late 1982, the capability for trading firms to report NMS trades to NASDAQ via their in-house computing systems was made available. This eliminates the need for a costly two-step process.

The Computer Assisted Execution System (CAES) was also made available in November, in pilot form, for trading NASDAQ NMS issues. At the end of the year, the NASD established a special committee to recommend ways in which CAES could be developed to make it an even more useful tool to subscribers.

Other New Services

Also under development in 1982 were two new automated services:

- The Trade Acceptance and Reconciliation Service (TARS) which will permit members to view compared and "trouble" trades on their NASDAQ terminals and to enter corrections; and,
- An "electronic bulletin board" which will enable members to exchange information about limited partnership interests available for secondary trading through NASDAQ System facilities.

Media Visibility for NASDAQ Securities

Newspaper Publication of NASDAQ Tables

Seventy-nine newspapers in the U.S. and two in Europe allocate space for the publication of the NASDAQ National List of 1,912 top-ranking NASDAQ securities. As shown on Page 12, there are two alternative sets of financial criteria for the inclusion of securities on the National List, the first set for operating companies, the second set for development companies without operating income. The financial criteria for the National List are basically similar to the criteria for listing on the AMEX.

A number of newspapers allocate space for more than the NASDAQ National List. *The Market Chronicle* and *Media General Financial Weekly* publish complete NASDAQ quotations (on 3,664 securities at the end of 1982); *Barron's* and *The Wall Street Journal* regularly publish not only the National List but also the Additional List of 1,040 NASDAQ securities (included in the list on the basis of their dollar volume trading); *The New York Times* and the *Sarasota Herald-Tribune* carry the more active upper half of the Additional List.

Newspapers with smaller financial sections publish abbreviated versions of the National List, or lists of NASDAQ securities of regional or local interest.

National List Newspapers

The seventy-nine U.S. and two European papers which publish the NASDAQ National List are:

Akron Beacon Journal
Arizona Republic
Asbury Park Press
Atlanta Constitution
Atlanta Journal
Baltimore Morning Sun
Baltimore News-American
Barron's
Bergen County Record
Birmingham News
Boston Globe
Buffalo Evening News
Camden (NJ) Courier-Press
Chicago Sun-Times
Chicago Tribune
Cincinnati Enquirer
Cleveland Plain Dealer
Cocoa (FL) Today
Colorado Springs Sun
Columbus (OH) Dispatch
The Commercial and Financial Chronicle
Daily Oklahoman
Dallas Morning News
Dallas Times-Herald
Denver Post
Des Moines Register
Detroit Free Press
Detroit News
Fort Lauderdale News
Fort Lauderdale Sun-Sentinel
Fort Worth Star-Telegram
Gannett Westchester Newspapers
Greenville (SC) News
Hartford Courant
Houston Chronicle
Houston Post
Indianapolis Star
International Herald Tribune (Paris)
Jacksonville Florida Times-Union
Kansas City Times
Los Angeles Times
The Market Chronicle
Media General Financial Weekly
Miami Herald
Minneapolis Tribune
New Haven Journal-Courier
New Orleans Times-Picayune
New York Post
New York Times
Newark Star-Ledger
Newport News (VA) Daily Press
Orlando Sentinel Star
Palm Beach Post
Passaic (NJ) Herald-News
Philadelphia Inquirer
Phoenix Gazette
Providence Journal
Richmond News Leader
Rochester Democrat & Chronicle
Rocky Mountain News
St. Louis Globe Democrat
St. Louis Post-Dispatch
St. Petersburg Times
San Antonio Express
San Diego Evening Tribune
San Francisco Examiner
San Jose Mercury
Santa Ana Register
Sarasota Herald-Tribune
Seattle Post-Intelligencer
Seattle Times
Springfield Republican
Tampa Tribune
Trenton Trentonian
Tulsa World
USA Today
Van Nuys Daily News
The Wall Street Journal
The Wall Street Journal/Europe
Washington Post
Youngstown Vindicator

TV and Radio Coverage of NASDAQ

Daily TV

ABC-TV
Cable News Network
ESPN Cable TV
Financial News Network
PBS Nightly Business News

Weekly TV

PBS Wall Street Week

Daily Radio

ABC Radio Network
AP Audio and Broadcast Wires
CBS Radio Network
Dowalert
Regional State Networks
Mutual Broadcasting System
National Public Radio
UPI Audio and Broadcast Wires

The Five NASDAQ Corporate Consultants and Their Regions

Five NASDAQ Corporate Consultants provide continual assistance to NASDAQ companies, and in 1982 some 300 companies took advantage of their services. These services are provided free of charge.

The task of the Consultants is to maximize for NASDAQ companies the benefits of the services which NASDAQ, the NASD and the OTC market have to offer. Specifically, the Consultants have helped NASDAQ companies to:

- Secure more market makers;
- Attain a greater degree of visibility;
- Work effectively with investment bankers;
- Plan their investor relations programs;
- Broaden their shareholder lists; and,
- Secure access to appropriate people in the securities industry and at the NASD to resolve problems.

The five NASDAQ Corporate Consultants and their regions are as follows:

Byron W. Cain, Sr. is the NASDAQ Corporate Consultant for the Central and Rocky Mountain States. He was President and Chief Executive Officer of Southern Union Company, a Dallas-based company with revenues in excess of $1 billion a year from gas, oil and real estate operations. Mr. Cain's address is 4112 Windsor Parkway, Dallas, Texas 75205, and his telephone number is (214) 741-5451.

W. Eugene Cartwright is the NASDAQ Corporate Consultant for the Far Western United States. He has been a Director of Merrill Lynch, Pierce, Fenner & Smith, Resident Vice-President Manager of the firm's Los Angeles office and Managing Director-Marketing for the Southwestern U.S. He can be reached at 515 Ocean Avenue, Suite 307 N, Santa Monica, California 90402 or by telephone at (213) 451-5204.

Douglas H. Curtis, the NASDAQ Corporate Consultant for the Midwest, is former Vice President-Finance of the NASDAQ-quoted Franklin Electric Co. and former Vice Chairman-Finance, Governor-at-Large and Chairman of the Corporate Advisory Committee of the NASD. He may be reached at Curtis Associates, G.B.M. Building, PO Box 443, Bluffton, Indiana 46714 or by telephone at (219) 824-5070.

Raymond J. Kiernan, NASDAQ Corporate Consultant for the Southeastern United States, was Vice President and a Director of Merrill Lynch, Pierce, Fenner & Smith, and has had over 25 years of experience in market making in OTC securities. He has been a Governor of the NASD and Chairman of the NASDAQ and Information Committees. His address is 4600 Ocean Boulevard, Suite 211, Boynton Beach, Florida 33435 and his telephone number is (305) 278-0118.

Lewis M. Weston, NASDAQ Corporate Consultant for the Northeastern U.S., was a General Partner of Goldman, Sachs & Co. until 1978. In his 27 years with the firm, he specialized in underwriting and securities analysis. He has been a Governor of the NASD and an Adjunct Professor of Finance at two New York schools. He may be reached by letter at the NASD's office at Two World Trade Center, 98th Floor, New York, New York 10048 or by telephone at (212) 676-8005.

Senator D'AMATO. Our third panel is composed of Mr. Thomas Unterberg, chairman and senior managing partner of L. F. Rothschild, Unterberg, Towbin; and Mr. Richard Jenrette, chairman of the board, Donaldson, Lufkin and Jenrette.

Thank you both for coming today.

First of all, let me say that I am extremely delighted that we have two such distinguished representatives of the industry, and two sets of leading firms who have distinguished themselves and the firms with their integrity and public service in the capital formation marketplace.

It should not be considered that this hearing is being held as a witch-hunt of any of the people who are participating.

Indeed, we are deeply grateful for their participation because the fact of the matter is that the investing public must be protected. The firms in this business want to see the highest possible standards in the industry so that the investing public will invest with confidence, particularly when their firms take a position, because the firms have put a great many years of effort and time and diligence in seeing to it that they promote the best product and they're not out there to promote companies that are going to lose or defraud the public or be a bad investment.

I want the record to state that quite clearly. This is in an effort to see to it that during these extraordinary times in the financial marketplace, during the huge increases in volume, that we see to it that the one, or two, or the small percentage of firms which would create havoc and will create harm to the small, unsophisticated investor should not put a cloud over the entire industry.

I'm fearful that we are going to see this kind of situation take place as some horror stories will undoubtedly unfold with companies that really should not be in this area.

So, what can we do to minimize these risks and assure the public confidence?

And I thank both of you gentlemen.

Whoever wants to proceed, please begin.

STATEMENT OF RICHARD H. JENRETTE, CHAIRMAN OF THE BOARD, DONALDSON, LUFKIN, AND JENRETTE

Mr. JENRETTE. I think, Mr. Chairman, I'll lead off.

Mr. Chairman, my name is Richard Jenrette and I'm chairman of Donaldson, Lufkin, and Jenrette, and currently chairman of the Securities Industry Association, the voluntary association of some 500 firms which collectively account for approximately 98 percent of all of the securities transactions in the United States.

In reviewing the subject of fraud and abuses in the new issue market, I think it is appropriate to take a few steps back and view this subject in the overall context of what has been happening in the U.S. capital markets.

EXTRAORDINARILY POWERFUL STOCK MARKET

Specifically, and most important, these events have occurred against the general backdrop of an extraordinarily powerful stock market.

The Dow Jones industrial average, which stood at 800 in August 1982, now stands well over 1,200 a little over a year later, a more than 50 percent gain.

Even more stunning, however, has been the market appreciation in smaller growth companies, specifically those related to high technology.

The Value Line Index, which is a broad-based index, has appreciated more than 80 percent since August a year ago.

The American Stock Exchange index—which is again, smaller companies—is up 64 percent.

An index of representative technology stocks prepared by Hambrecht & Quist shows more than 100 percent appreciation in this same time period.

The Alliance Technology Fund managed by our firm was up 132 percent from August 1982 to August 1983.

Such large gains obviously have been a magnet in attracting newcomers to the stock market.

Trading volume on the New York Stock Exchange, the AMEX, and over-the-counter markets have mirrored this increased investor appetite for equities.

Volume on the New York Stock Exchange, which averaged 49 million shares a day in 1981, jumped to 65 million in 1982, and has averaged 85 million shares a day in 1983.

These daily averages have been punctuated by frequent days when trading exceeded 100 million shares on the New York Stock Exchange.

The American Stock Exchange volume this year is running 75 percent ahead of last year.

But perhaps the most stunning of all, has been the growth in over-the-counter trading, which has been referred to earlier, which tends to reflect investor interest in smaller companies.

Using NASDAQ as a proxy, volume has grown from 33 million shares a day in 1982 to more than 60 million shares a day in 1983, nearly a 100-percent gain in 1 year.

Options volume on the CBOE has increased 2½ times in the last 3 years.

Taking advantage of this unusual investor appetite for equities, underwriters, and corporate issuers have moved swiftly to tap this unparalleled demand which, I would point out, followed 15 years of virtually no appreciation in common stock prices in the United States.

While final figures are not yet available, it appears to us that publicly underwritten issues of equity securities will exceed $40 billion this year—this includes some secondary issues—an alltime record, up from $16 billion in the prior year and a more normal $4 to $5 billion in earlier years.

In addition, this year more than $2 billion of new venture capital will be raised for smaller companies, double the level of the 2 prior years.

These publicly underwritten offerings for more than 1,200 companies, plus the major capital funds, benefit primarily small, emerging growth companies.

Since these smaller growth companies have been demonstrated to be the greatest source of new jobs, we suspect that this capital raised has been an important element in reducing unemployment in the United States in recent months.

The new capital most importantly will give a major lift to new technologies in the United States and will aid American companies in competing with the Japanese and other foreign competitors.

What all of this means is that when reviewing some of the shortfalls of the past year, one should not lose sight of our industry's tremendous accomplishment in raising record amounts of new, permanent equity capital for U.S. companies.

I think all of us can take a great deal of pride in what has been accomplished.

Unfortunately, nothing is all good and there have been some negative aspects to this otherwise very positive increase in investor increase in equities.

As outlined in the Venture magaine article. a few unscrupulous operators have used this booming environment to prey on the gullibility of smaller investors who tend to get carried along by the euphoria of rising markets.

I am pleased to report that at SIA we are not aware of any activity emanating from our member firms in this category we are discussing.

I might add——

Senator D'AMATO. May I ask——

Mr. JENRETTE [continuing]. SIA members are screened. Anyone who——

Senator D'AMATO [continuing]. What approximate percentage of the new offerings—do your member firms account for, if you have a percentage?

Mr. JENRETTE. Well, total volume we do about 98 percent. That would probably be true in the new issue market.

Mr. UNTERBERG. Or higher.

I would venture that it's higher than that percentage.

Senator D'AMATO. Well, of course, that small percentage outside needs the most careful scrutiny.

Would that be fair?

Mr. UNTERBERG. Yes.

Mr. JENRETTE. These are the kinds of firms that don't join the SIA, or if they apply, we don't let them in.

While we do not in any way condone whatever abuses have occurred, SIA at this point is not proposing any remedial legislation.

The aggregate dollar value of these questionable new issues represents only a tiny percentage of the total capital raised.

It is also likely that we will not witness any time soon such a speculative market which will act as a magnet for questionable corporate issuers or underwriters. Normal markets are simply not conducive to such speculation.

We believe our industry's overall experience in the extremely strong and sometimes speculative stock market of 1982–83 is a tribute to the self-regulatory policy mechanisms which have been established within our industry and proved to work well such as just described by Gordon Macklin.

In conclusion, Mr. Chairman, I would like to state that I personally appreciate your efforts to educate the public on the risk involved in buying speculative securities.

And from a personal point of view I appreciate your concern for such activity which ruins the reputation of legitimate underwriters of securities.

You deserve praise in my judgment for an outstanding job of raising new capital for American business.

Thank you.

Senator D'AMATO. Thank you.

STATEMENT OF THOMAS I. UNTERBERG, CHAIRMAN AND SENIOR MANAGING DIRECTOR, L. F. ROTHSCHILD, UNTERBERG, AND TOWBIN

Mr. UNTERBERG. I'm Thomas I. Unterberg, chairman of L. F. Rothschild, and a member of the executive committee of SIA.

My firm and its predecessors have been active in initial public offerings since the late 1950's.

To put this in perspective, Unterberg & Towbin, my old firm, did approximately 100 million dollars' worth of new issues in 1972, the peak of that market. So far this year L. F. Rothschild has done over $1¼ billion of new issues.

For the most part we have been enjoying a strong new issue market since the beginning of 1980.

1980–83 MARKET CONTRASTS SHARPLY WITH 1968–72 MARKET

This market contrasts markedly with the last buoyant initial public offering market of 1968–72. To get some perspective, we might look at the previous period.

In 1968 $1.7 million was raised in this market, 649 offerings averaging less than $3 million.

This progressed until 1972 when there was $2.7 million raised, 568 offerings, or the average size offering was $5 million.

It is important to note that the underwriters of those issues were not the major Wall Street investment bankers. They were the so-called submajor firms and the regional firms, a few specialists in initial public offerings, plus a whole host of small firms in New York, New Jersey, and elsewhere that were under constant surveillance of the NASD new issue committee.

The ensuing recession which, along with May Day—deregulated commission rates—effectively wiped out most of these underwriters between the years 1974 to 1977. This is indicative of the fact that the initial public offering market sank to a low of $51 million in 1974.

Before I comment on today's market, I would like to preface my remarks by saying that they are limited to the segment of the market which involves initial public offerings of at least $5 million.

And looking at that segment of the market, it has grown dramatically from one-quarter of a billion dollars in 1978 to $10.5 billion through the first 10 months of 1983.

The $10.5 billion was raised by 522 companies.

Today, at the end of 1983, the market has flattened out, is less buoyant, but is still having a reasonable high level of activity.

So far this year it's been a $1 billion a month business, and the average size per issue has been approximately $20 million.

If you look behind the issues themselves, you can see that the catalyst for this marked increase in business has been the large amount of money invested in venture capital during the late 1970's and the 1980's.

A typical issue making an initial public offering in 1972 would today be getting an initial financing in a private financing from the venture capital commuity.

Prepublic venture capital placements today of $15 to $20 million are not at all unusual. It is estimated that so far in 1983 $2 billion of this kind of prepublic financing has been done, which interestingly enough is about the same size as the entire new issue market of 1972.

The result of this is that the companies going public today are of a much higher quality than 10 years ago.

There is a substantially more advanced stage of development both in terms of the product, revenues, and profitability.

While there are certainly speculative companies with no history of earnings raising funds publicly, I believe that they are more than balanced by the medium-sized and even semi-mature companies going public for the first time.

I think that indicative of this fact is that over the last 3 years 17 companies going public for the first time have each raised in excess of $100 million.

It should also be noted that the underwriters of these issues today are not the small firms, are not the regionals, but the major investment banks.

Nine of the ten leading underwriters in the area of new issues are major investment banking firms. The tenth is a specialist in initial public offerings.

Today, every retail and institutional salesman of every major Wall Street firm has new issues as part of the product he offers his clientele.

Most of the larger issues are being done by the major firms. The average size of new issues done by my firm this year has been in excess of $36 million.

As opposed to the 1968 to 1972 period, I believe that Wall Street has legitimized the new issue business today. This post-1980 phenomenon represents a large potential source of capital for the reindustrialization of America.

While we are not prepared at this time to say this will continue to be a $12 billion annualized business, it is our best estimate that sometime in the 1984–86 timeframe today's level of activity will be surpassed.

We believe with the efforts of the venture capital community and the investment banking community, plus the institutional and retail purchasers of this product, that it will continue to be an even more important business and a more important source of capital for this country than it is today.

Thank you.

Senator D'Amato. Thank you very much.

May I ask either of you gentlemen what recommendations you might have in attempting to minimize abuses and manipulative activity in the new offerings market?

I don't know whether you were here during the full course of the hearing, but regarding, for example, the hot issues market. I think we can distinguish that what we are talking about are the penny stocks.

Should, for example, the Commission have the ability to require, those people who have committed felonies and who are major stockholders, make that information available to the public?

Mr. Jenrette. I think that that's probably a good idea.

In fact, most of us in our hiring of people do carefully screen the—check their former employment. It's quite a detailed investigation that one goes through.

And, therefore, many of these people who are excluded from what I might call the legitimate firms find their way to some buggy shop.

SEC NEEDS TO SCREEN BROKER-DEALERS

Senator D'Amato. Should the SEC also have the ability to preclude those people who have been suspended from the commodities industry from participating in the securities industry?

Mr. Jenrette. It seems it should be reciprocal.

Mr. Unterberg. I would agree with that 100 percent.

Senator D'Amato. I think at least in those two specific areas, those are the things we can look forward to both by way of Chairman Shad's affirmative statement that the Commission will be looking at that, and in terms of the legislative effort that might have to come from the Congress to give the SEC that ability.

Mr. Jenrette. Let me say one more thing, Mr. Chairman.

Sometimes in—when someone is discharged perhaps for questionable activity by issues that are not suitable for a client, and the person is discharged, it's sort of a gray area, and you don't want to blackball him forever. Maybe they'll learn. So there is a fine line as to——

Senator D'Amato. There would not be a blanket prohibition, but it provides discretionary authority to the SEC.

Mr. Jenrette. Yes.

Senator D'Amato [continuing]. The SEC would have discretion—because there are, as you say, extenuating circumstances.

There is also the factor of rehabilitation and there may be mitigating circumstances.

I don't think we want to develop a society that says unequivocally that one is precluded from earning a livelihood.

But would you describe any other methods that you might think of or do you have any recommendations in terms of attempting to minimize the abuses and the manipulative activities?

That becomes important given the testimony of both of you gentlemen as to what the capital requirements of this Nation are going to be, if we are going to continue to vitalize America and keep it productive.

Mr. Unterberg. Well, I would like to say, in terms of the financial community, I think we made huge strides in eliminating manipulative kinds of abuses over the last 10 or 15 years.

As this business is now centered in the major investment banks, to the best of my knowledge there is practically—we never see manipulation of any degree of a new issue. I think it's become totally legitimized if that's the proper word.

Senator D'Amato. Mr. Jenrette, any comments?

Mr. JENRETTE. Well, I certainly agree with Tom that we don't see very much manipulation but we aren't dealing in penny stocks.

Senator D'AMATO. That's important for your industry as well.

When I say your industry, I mean it in reference to those stocks and those offerings outside of the penny market. Because everyone's part of the broader "securities industry," unfortunately we must all be concerned about this situation.

So as it relates to that, I think you have a very real stake in seeing to it that the best efforts possible are undertaken to control even that limited segment, although it may only account for $400 million of the $12 billion industry or the new offerings of the industry.

And although there may be a substantial part within that $400 million which is an honest-to-goodness manifestation of entrepreneurial spirit that we need and we want to encourage, no one is going to say that because the issuer is small, we want to preclude him. I don't think that is something that would be in our best interest.

So it becomes important to attempt to deal with the abuses.

Mr. JENRETTE. Well, the problem is——

Senator D'AMATO. Assume you had an offering where someone said, "We want to raise $3 million and we are not even telling the investor what we are going to do"?

Doesn't that raise in your mind some kind of question?

Your firms would never undertake that kind of a thing.

Mr. JENRETTE. No. It just goes back to the basic problem that people don't read the prospectus. And it seems if you disclose everything, you can't prosecute them.

Senator D'AMATO. How can they do this? If an investment firm had any really long-term clients, long-term investors, would it allow that kind of thing to come into being?

Mr. JENRETTE. I think——

Senator D'AMATO. That leads to another question.

Due diligence: Do we have due diligence efforts within the industry relating to hot issues? Are they sufficient?

Mr. UNTERBERG. Well, when we define due diligence, it represents the work we do in investigating potential issuers before we raise the money for them in public.

Senator D'AMATO. You're already saying, here, you have a good chance.

Mr. JENRETTE. Well, your reputation——

Senator D'AMATO. Your reputation says that.

Mr. UNTERBERG. I think that's true. We investigate the company as deeply as we possibly can, make a judgment as to its value and raise money from the public. And hopefully we are right more often than we are wrong.

But——

Mr. JENRETTE. If our due diligence is wrong, we'll be sued. Our firms have capital whereas a small penny underwriter has no—there is nothing to sue.

Mr. UNTERBERG. Which is another major change since the last time we had this kind of a market; that is, new issues are being done by firms with very deep pockets.

And it's not a question of not having done due diligence. It's a question today of anytime you do an issue that is going to sell substantially below the issue price, you have to expect some kind of litigation.

Senator D'AMATO. Then the question comes up, how do we deal in that small percentage, small issues, small venture capital, to see to it that we protect their right to enter the market and enhance it and to see to it that it's the kind of situation where there is nothing similar to the situation where there is a 21-year-old kid who says he's unemployed and he says he's going to devote 10 percent of his time to the management of the issuer, and he has an associate who is going to devote 3 percent of his time to the issuer.

Would I be out of order in saying or suggesting that NASDAQ should do more in that area?

Something is wrong, gentlemen. Something strikes me as terribly wrong. You just can't say buyer beware, we have done all we can.

SECURITY INDUSTRY HAS A RESPONSIBILITY TO ACHIEVE LEGITIMACY

Now, I know everybody is apt to shudder—John Fedders said he would oppose the Federal Government having any kind of review with respect to merit. Well, he might.

But I think the industry certainly has a responsibility to itself and its own legitimate efforts. I would suggest tougher merit requirements in order to give even greater strength and legitimacy, not only to those large offerings, but to those small offerings.

What would you suggest?

Mr. JENRETTE. I think one problem, some of the solutions could block off some legitimate operations.

It wasn't too many years ago when I was trying to raise $100,000 to start Donaldson, Lufkin, and Jenrette. It probably didn't read very well.

Senator D'AMATO. OK.

Mr. JENRETTE. But I think you have a lot of capital that probably——

Senator D'AMATO. Let me stop right there. That's not true.

Because you had your ability, the people were there, you stated what you were going to attempt to do. You didn't say "We have no idea." I picked this as an example; maybe it's an extreme example.

Mr. JENRETTE. I'm not saying that we have to throw up our hands in despair and say nothing can be done.

But clearly a lot of these small things are done by unsophisticated people. The danger of squashing that, that is the risk we have to make.

Mr. UNTERBERG. I would also submit that the unscrupulous people in this industry are very smart and they will meet whatever merit requirements you would come up with.

I would go beyond that and get more involved in how the securities are distributed. We have all seen these prospectuses and say, how in the world will anybody buy these securities. But somebody buys them.

I think you have to look into on what basis they are being bought, how are they going to be distributed, how are they being paid for, and what is being told to the potential purchasers.

Senator D'AMATO. How did you buy this stock?

This is Morgan Hardiman. You bought it and they didn't give you a prospectus. What motivated you?

Mr. Hardiman. The most I could have lost was $160, and it was on the word of the broker who had last recommended a hot issue 10 years ago.

Senator D'Amato. What happened to that one?

Mr. Hardiman. That apparently had done very well.

Senator D'Amato. Did you invest in that one?

Mr. Hardiman. No. I never heard of this guy 10 years ago. I have yet to read my prospectus.

Senator D'Amato. One final question.

I don't wish to intrude upon your time and I'm deeply appreciative of your coming forth today and giving this Senator a better understanding.

Let me assure you there are many back in Washington who have little appreciation for what the new issues market has done, the importance and significance of the capital contribution to our economic recovery and the importance of maintaining it at whatever the levels are and seeing to it that it can prosper.

I'm deeply appreciative on the personal side and I think we will be able to come forth with some legislative proposals and some proposals from the Commission that will help strengthen and give vitality to the market and afford some protection to investors without undue Federal regulations. It's important that we have this.

But the question is, Should underwriters be required to have certain levels of capitalization at least to exclude the bucket shop type of firm so that there is something to go after?

What is your thinking there?

Mr. Jenrette. To join the New York Stock Exchange.

Mr. Unterberg. We can't underwrite more than 20 times our net capital.

But believe me, Senator, whatever capital requirements are set up——

Senator D'Amato. They'll come up with them?

Mr. Unterberg [continuing]. They'll come up with them.

Senator D'Amato. In other words, you're saying that if you have someone who has figured out a way to sell these stocks that have no real value, you give us a merit protection, so they'll have someone who will say "I was involved in the business for so many years and I intend to put in so much of my time" and the underwriters themselves will come up with the capital because this is a scheme by which they can get great profits and throw them off.

What you're really saying is that you can close certain loopholes, you can make the disclosures so starkly revealing, that if you see you have someone who has been convicted of felonies and is a 60-percent shareholder, perhaps that will dissuade a greater percentage of the public.

And you really believe that is really the way to take it. Is that fair?

Mr. Jenrette. Yes.

It's obviously much easier to open a small, little underwriting shop in a bank where you have a State charter.

Senator D'Amato. Well, we don't want to preclude that from happening in the future.

Mr. Jenrette. No, you don't.

Gentlemen, let me thank you. You have done this committee and this Senator a great service in participating.

I might also suggest that the record will remain open for at least the next 30 days. And if there is any information, other than that testimony which you have given, that you wish to submit and that you might think would be helpful in the committee's deliberations, we would be very pleased to receive it.

This committee stands in recess.

[At 1:30 p.m. the subcommittee was recessed.]

[Additional material supplied for the record follows:]

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December 15, 1983

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Testimony of Michael Unger
President, North American Securities Administrators Association

Before the Subcommittee on Securities
U.S. Senate Committee on Banking, Housing and Urban Affairs

December 15, 1983

Mr. Chairman and Members of the Subcommittee:

I am Michael Unger, President of the North American Securities Administrators Association (NASAA). NASAA is the association of the 65 state and provincial securities administrators from the United States, Canada and Mexico, charged with the responsibility of administering and enforcing securities laws. NASAA works to protect investors and to ensure that the securities markets operate with a minimum of abuse.

The Subcommittee's focus on the hot issues market is most timely and we appreciate the opportunity to share our perspective with you. State securities regulation concentrates on these kinds of stock offerings and NASAA is currently preparing a study on this market. We will provide it to you after the first of the year. For now, we are pleased to share our general thoughts on the problems we see everyday.

Much has been said over the past year or so about the bull market in equities. How high will the Dow-Jones go? Has it peaked or is this week just a pause? These are the questions that have understandably gripped the attention of brokers and investors alike.

Often ignored in the swirl of optimism and avarice has been the soft underbelly of the boom -- the hot issues market. That is the market in which hype and manipulation often overwhelm innovation and productivity. It is the market in which promoters and brokers aim to make their money on the sale of the stock, not the success of the company.

Consider the Lezak Group, Inc., whose 1983 prospectus explained the company "has engaged in no business whatsoever" and "does not know what business it will engage in." Or Target Industries, a company "with no production or sales" which disclosed that "as a condition of his 1981 commodity conviction probation," the company's president is "barred from associating with" the major stockholder.

Much of the deregulatory philosophy that is transforming the financial markets seems based on the assumption that any transaction between a willing buyer and willing seller contributes to economic growth. Yet the current hot issues market suggests that an open market is not necessarily a productive one. In this market, small companies, many of them with a high technology angle, sell stock to the public for the first time. Since everybody knows, or at least has heard over cocktails, that high tech will play a big role in the future of the economy, there is strong investor interest in most stocks with a high tech label. Thus, after the initial offering, the prices of these stocks often go up — at least for awhile.

This investor interest has convinced many small companies with useful products to sell stock to the public. With the additional capital, these companies can expand their operations, hire more workers, and produce more. In these companies, the owners make money as their firms earn profits.

The strong market has, however, also attracted less scrupulous promoters who realize, correctly, that there is money to be made even if the companies are ultimately unprofitable or simply scams. A 1983 survey by Venture magazine revealed that last year almost half of the companies going public with stock priced under $1.00 "had participants with histories of securities injunctions, violations, fraud, or associations with reputed crime figures." Many of these hucksters make their money by selling the initial offering to uninformed investors and by trading the stock while its price rises. Often they rely on hard sell, cold calls to these investors or tie sales of worthless stocks to opportunities to buy more popular ones. Their investment strategy is the "greater fool" theory. (Regardless of how unrealisticly high is the price I paid for a stock, surely there is a "greater fool" who will buy from me at a still higher price.) As in the children's game of musical chairs, at some point, the music stops and someone's a loser. The price peaks and the later buyers lose money. But before that, millions of dollars may have been made by the brokers who marketed the stock and by the insiders who understood the game.

Much of the burden of policing this market falls to the states -- and appropriately so. We are closer to investors and more familiar with local markets. Often we can weed out fraudulent offerings that sprout in a hot issues market before investors have lost their money. Likewise, since we are generally less burdened with bureaucratic red tape, state regulators can respond more quickly to complaints of misleading sales practices and threats of market manipulation. But, in a hot issues market such as the current one, with initial public offerings topping $13 billion, our resources, as well as those of the Securities and Exchange Commission, are strained. The problems that surface in such a market highlight the need to carefully weigh the costs, as well as the benefits, of deregulatory initiatives.

Over the past 70 years, America's capital markets have become the cleanest and most efficient in the world because we have developed complementary state and federal regulation to keep it that way. These regulatory safeguards can protect investors and the whole economy from wasting scarce capital resources in fraudulent or worthless deals. It is no accident that, when that regulatory system is overburdened, we see a boom market in fraud.

We applaud the Subcommittee for investigating the dark side of this bull market. State securities regulators have extensive day-to-day experience with its problems. And, because of the genius of our federal system, the states have a variety of perspectives on it that may be useful to the Subcommittee. We look forward to being of whatever assistance we can.